Union Calendar No. 264

97TH CONGRESS
2d Session
HOUSE OF REPRESENTATIVES
REPORT
No. 97-436

THE 1982
JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

FEBRUARY 1982 ECONOMIC REPORT OF THE PRESIDENT

TOGETHER WITH

ADDITIONAL VIEWS

MARCH 1, 1982.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

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LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., March 1, 1982.

Hon. THOMAS P. O'NEILL, JR.,
Speaker, House of Representatives,
Washington, D.C.

DEAR MR. SPEAKER: Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the Report of the Joint Economic Committee containing its findings and recommendations with respect to each of the main recommendations made by the President of the United States in his February 1982 Economic Report. This Report is to serve as a guide to the several committees of Congress dealing with legislation relating to economic issues.

Sincerely,

HENRY S. REUSS, *Chairman.*

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HOUSE OF REPRESENTATIVES

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REPORT ON THE FEBRUARY 1982 ECONOMIC REPORT OF THE PRESIDENT

MARCH 1, 1982.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. REUSS, from the committee of conference, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[Pursuant to sec. 11(b)(3) of Public Law 304 (79th Cong.)]

This report is submitted in accordance with the requirement of the Employment Act of 1946 that the Joint Economic Committee file a report each year with the Senate and the House of Representatives containing is findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report. This report is to serve as a guide to the several committee of Congress dealing with legislation relating to economic issues.

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INTRODUCTION

By Chairman Henry S. Reuss and Vice Chairman Roger W. Jepsen

We are pleased to transmit to the Congress and to the public the 1982 Annual Report of the Joint Economic Committee.

In this Report, we continue the practice, begun in last year's Annual Report, of providing separate Views of the Democratic and the Republican Members. This practice reflects the differences of philosophy and of policy between us, and meets in a constructive way the need for a national debate on economic policy issues. We are proud of the close working relationship between Members of both Parties which has prevailed on the Committee in the 97th Congress, and which has made possible this setting forth of our different perspectives in this Annual Report.

Bipartisan cooperation and constructive debate has been the rule on the Joint Economic Committee in the past year. This Report is the fifth Report of the Committee in this Congress; of these, three have been issued on a bipartisan basis, reflecting important areas of policy on which Members of both parties have come to agreement: productivity, high-speed passenger rail service, and the regulation of trucking. In addition, the Committee has held over one hundred days of bipartisan hearings, and has continued to serve it vital research role on behalf of the Congress and the public.

We expect to continue our cooperation in the future, and look forward to the contribution the Joint Economic Committee will make in the months ahead.

Democratic Views

on the

February 1982 Economic Report of the President

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A. End the Recession 64

Recommendation No. 1: End the Recession

We reject the idea that unemployment is necessary to fight inflation. The Administration's economic strategy is causing vast and unnecessary hardship, with a virtual guarantee that huge future deficits will overwhelm any temporary abatement of inflation once economic recovery is permitted to begin. We believe that durable price stability and a balanced budget can be achieved only in the context of economic growth; therefore, an early end to the recession is imperative.

Recommendation No. 2: Immediate Relief for the Unemployed

Unemployment insurance coverage is inadequate in this recession and must be extended to assure a maximum of 39 weeks of benefits in all 50 States. The effective date of the new provisions regarding Federal loans to State unemployment insurance programs should be delayed by one year, to minimize the need for States to institute cutbacks in benefits in the midst of recession. Congress should also repeal the changes in the Extended Benefits Program that require higher State trigger levels and a new method of calculating trigger unemployment rates.

Eligibility for the Targeted Jobs Tax Creit should be extended to workers unemployed longer than 15 weeks and to workers whose earnings from previous emplyment were less than $6,500 a year.

B. Monetary Policy: Recommendations 3-10 69-97

Recommendation No. 3: Bring Interest Rates Down and Keep Them Down

The recession of 1981 was caused by unnecessarily tight money and destructively high interest rates. It has wrought massive damage on housing, the automobile industry, small business, agriculture, productive capital investment, and other productive uses of credit. The Congress, Administration, and the Federal Reserve should concert all efforts to repair this damage, which can be done only by bringing about a lasting climate of lower and more stable interest rates.

Recommendation No. 4: Do Not Tighten Money

Monetary policy should return immediately to a path of steady, moderate restraint consistent with lower inflation and economic recovery in 1982. Current Federal Reserve plans appear to call for a continued tightening of money this year. Such a tightening would not be consistent with economic recovery under realistic inflation assumptions, and would instead produce a rapid return of intolerably high interest rates soon after the recession abates. A more accommodating monetary policy than currently planned would help bring interest rates down without risking higher inflation.

Recommendation No. 5: Low Real Interest Rates Should Be the Immediate Goal

Real interest rates in 1981 were kept high by policy as inflation fell. The Federal Reserve, Administration, and the Congress should agree on the immediate objective of restoring low real interest rates, defined as bringing long-term interest rates back to their historical relationship with current and expected rate of inflation. If inflation continues to decline, policy should bring long-term interest rates down rapdly, to prevent real interest rates from rising.

Recommendation No. 6: Practice Credit Conservation

The Administration and the Federal Reserve should encourage the banking system to develop an effective means to deter destabilizing bursts of bank-financed lending for unproductive purposes such as large corporate take-overs and speculation in commodities, collectibles, and land. Such measures will have the effect of conserving scarce credit resources in times of need for the use of small business, farmers, housing, automobile financing, and productive capital investment.

Recommendation No. 7: End the Interest Rate Wars

In 1981, U.S. high interest rates damaged the world economy and undermined confidence in the economic leadership of the United States. These severe international repercussions must not be allowed to continue. High interest rate competition should be replaced by much closer international coordination of economic policy.

Recommendation No. 8: Improve Federal Reserve Accountability and Policy Coordination

For the past decade, evidence has mounted that there are fundamental flaws in the procedures of monetary policy formation and oversight. These flaws were only partly corrected by the shift from interest rate to monetary targeting in October 1979; indeed, that change has brought new difficulties to the fore. We call for the Federal Reserve to take a fresh look at the formation of monetary policy and report to the Congress. Such a report should have six specific objectives:

To improve the quality of information about monetary policy objectives made available to the Congress and the public;

To improve the coordination of monetary policy, fiscal policy, and other tools of economic policy;

To provide guidelines for the conduct of monetary policy in times of rapid financial innovation and change in monetary instruments;

To provide guidelines for the conduct of monetary policy in the face of supply shocks;

To evaluate the instability in recent years of the demand for money, and recommend changes in monetary policy procedures that may be necessary as a result of this development; and

To devise ways to guarantee that Federal Reserve policy takes full account of the legitimate interests of industry, agriculture, and commerce, including small business and housing, as stipulated in the Federal Reserve Act.

Recommendation No. 9: Very Short-Run Money Volatility Is Not a Problem

We disagree with the view that very short-run volatility of money growth significantly damaged the economy in 1981. We urge that this criticism of the Federal Reserve be dispensed with.

Recommendation No. 10: Reject the Gold Standard

All forms of a return to the gold standard should be rejected by the President, the Administration, and the Congress.

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C. Fiscal Policy: Recommendations 11-18 98–107

Recommendation No. 11: Promote Economic Recovery Now and a Return to a Balanced Budget

The tax cuts scheduled to go into effect on July 1, 1983, should be deferred, and reviewed in light of the economic situation and the state of the budget next year. Indexation of the personal tax brackets to the Consumer Price Index should be repealed. This clear signal of responsible future tax behavior, with its resulting sharp diminution of the future deficit, will help to lower interest rates now, thus providing needed stimulus and promoting a rapid recovery from the present recession.

Recommendation No. 12: Review Tax Expenditures

Efforts to raise additional revenues in later years should begin with a comprehensive review of tax expenditures.

Recommendation No. 13: Excise Taxes

We oppose regressive increases in Federal excise taxes solely to balance the budget. Such excise tax increases are inflationary and unfair in their incidence. Excise tax increases should be considered only where they serve a compelling public interest.

Recommendation No. 14: No Value-Added Tax

We oppose proposals to institute a national sales tax or value-added tax. Such a tax would fall disproportionately and unfairly on low- and middle-income people, thereby compounding the loss in real income they have suffered in recent years. In addition, introduction of a VAT would add to inflation in the short run.

Recommendation No. 15: Corporate Taxes

The Economic Recovery Tax Act of 1981 provided for accelerated depreciation as we had recommended in our last Report. However, there remains a danger that, as the rate of inflation falls, the new system will become distorted in favor of equipment and machinery and against long-lived structures at low rates of inflation. Should this happen, consideration, should be given to measures such as open accounting, which would restore neutrality of the depreciation schedules with respect to types of investment, and eliminate any danger of negative effective tax rates. Provisions providing for tax leasing should be repealed or sharply overhauled to repair abuses, thus saving up to $5 billion per year.

Recommendation No 16: Spending

Further consideration of deep reductions in spending for social programs should be deferred until recovery from the current recession is well underway, except that the Administration and Congress should continue aggressive efforts to eliminate waste and mismanagement. The projected increases in defense expenditures are too large and should be scaled back.

D. Fairness: Recommendation 17 105

Recommendation No. 17: Fairness

The Reagan Administration has turned its back on the principles of fairness and opportunity for all which for 50 years have underpinned our society. This Administration is leading America toward greater unfairness by all its policies—tax, expenditure, monetary, regulatory. Ever-greater inequities diminish the traditional American value of economic opportunity, reduce the prospects for sustained economic growth in which all share, and threaten national unity. We urge that Congress defend the principles of fairness and equal economic opportunity, in its tax, spending, and regulatory decisions.

E. Structural Reform: Recommendations 18–25 107–137

Recommendation No. 18: Basic industries

We must address the problems of those basic industries, including steel, automobiles, and aircraft, which form the backbone of America's industrial structure. Future policies must stress modernization, reorganization, and adjustment, and must include strong and clear performance criteria. Policies to promote the adjustment of firms should be accompanied by and coordinated with policies promoting the adjustment of workers and communities.

Recommendation No. 19: Promote Catalysts

An American approach to industrial development should emphasize industries which can act as *catalysts* to economic development and job creation. A catalytic industry may be defined in any of several ways:

As one with extensive backward and forward linkages in the economy, so that strong advantage in that industry leads to strong advantages in a wide array of final products. The steel industry played this role in past decades for a wide range of fabricated projects. Today, the semiconductor industry is the catalytic center of industries as varied as computers, robots, telecommunications, and a host of electronic products.

As one in which the United States has valuable and underexploited resource advantage, such as coal.

As one in which, due to past imbalanced patterns of development, unique opportunities exist, such as regional high-speed passenger rail.

The role of government in promoting catalysts should vary according to the situation, but, in all cases, the objective is the same: to foster public-private cooperation and a climate in which economic development can take place.

Recommendation No. 20: Maintain Infrastructure

Investment in infrastructure—roads, bridges, water systems, ports, rails, utilities, and other physical support systems—must be restored to adequate levels. The ability of State and local governments to meet their responsibilities in this area has been sharply impaired by recent budget cuts. The urgent and over looked task of restoring our infrastructure should take priority over certain other engineering and development expenditures which the Administration continues to support. Soil erosion is a serious problem and should be treated as an urgent item of rural infrastructure maintenance.

We propose that:

Remaining funds in the budget for interstate highway construction in urban areas be redirected to maintenance of this system.

Department of Energy funds be reallocated from exotic and uneconomic projects in the nuclear field, including the fast breeder reactor, and spent instead on energy conservation and accelerated conversion of electric power generation to coal.

Certain unnecessary projects of the Corps of Engineers and Bureau of Reclamation be canceled and the resources invested instead into upgrading ports and other high priority projects.

The Department of Agriculture continue on an urgent basis a national evaluation of the problem of soil erosion, and programs to combat this, including measures to promote conservation tillage.

Recommendation No. 21: Restore Housing

For 50 years, homeownership has been a basic objective of national economic and social policy, and the housing industry has been one of our largest employers. Yet, certain supporters of the Administration's program advocate a deliberate strategy to "shift resources" from housing into the military and into capital investment. We reject such a strategy. America's housing industry can come back, if interest rates are brought down and kept down.

The Administration and the Congress should reject proposals to dismantle or to curtail sharply the activities of the Federal National Mortgage Association, Government National Mortgage Association, and Federal Home Loan Mortgage Corporation. Sufficient funding should be provided to these institutions to ensure that they can make an adequate response to the serious needs of homeownership and the housing industry.

E. Structural Reform—Continued

The Administration and the Congress should also reject proposals to dismantle further programs which help house low- and moderate/income families.

Recommendation No. 22: Science and Technology

Administration proposals to curtail sharply government support for civilian research and development, and to impose new requirements on scientists to submit to government censorship because of possible national security concerns, threaten to force sharp reductions or shutdowns of government laboratories and reductions in the supply of trained manpower for industry and universities to diminish the level and quality of university-based research, and to lessen the contributions of science and technology to improvements in the growth of productivity. Congress should reject such proposals.

Recommendation No. 23: Labor

The Committee rejects efforts by the Administration to deemphasize the role of labor in the production process. In the face of massive and growing unemployment, Federal manpower training programs should be maintained at least at reduced Fiscal year 1982 levels. Greater private participation in the design and conduct of Federal manpower programs is warranted.

Recommendation No. 24: Needed: Skilled Labor

Maintenance of existing youth and unskilled labor training commitments should be accompanied by a comprehensive review of Federal training programs to meet the emerging need for additional adult retraining programs. Youth and adult training programs should emphasize emerging skilled occupations and employers should be encouraged with tax credits to fill labor-short skilled occupations through expanded on-the-job training. Special attention must be given to the skilled labor needs of small business in the design of new training initiatives.

Recommendation No. 25: Federalism

State and local governments have borne a disproportionate share of Fiscal Year 1982 budget cuts and fiscal distress is widespread. At the same time, promised benefits from the Administration's Economic Recovery Program have not materialized for most cities and States. Additional budget cuts which adversely affect State and local governments should not be made in Fiscal Year 1983.

If and when additional consolidation of categorical grant programs into block grants are considered, they should be introduced gradually, so that States and localities can do the necessary planning without unnecessary disruption. We reject the effort to use block grants as a vehicle to force service cuts.

We support efforts of State and local government officials to begin a "sorting out" of Federal, State, and local responsibilities. However, we believe that, because the design and functions of government are extremely complex and technical, they cannot be recast with the mere stroke of a pen. This process requires careful planning and deliberation.

At the same time, we believe the Federal Government itself must be made to work more efficiently and deliver better results with the taxpayers' dollars. We endorse the Bolling-Roth bill to create a Presidential Commission on More Effective Government.

We urge that the Commission be set up quickly so it can begin to grapple with the complexity of making governmental work better at all levels.

F. Fighting Inflation: Recommendations 26–30 144–155

Recommendation No. 26: A Cooperative Policy To Fight Inflation

In past years, we have consistently called for an incomes policy as a necessary component of a comprehensive strategy against inflation. This year, we repeat that recommendation. An incomes policy should take the form of a national bargain between government and labor, with business participation. Such a bargain must be founded on principles of fair treatment, and its details must be worked out in discussions between those who would be a party to it.

Government should guarantee to labor that workers will not suffer unfairly as a consequence of good-faith cooperation in fighting inflation.

Recommendation No. 27: Promote Energy Security

We must continue to promote energy conservation; therefore, we oppose the reallocation of Energy Department resources from conservation which the Administration has effected. Enhanced development of coal is vital, as discussed elsewhere in this Report. In addition, we should encourage development of improved techniques for enhanced oil and unconventional gas recovery, and continue to fill the Strategic Petroleum Reserve at a satisfactory rate. These measures would work to reduce the sensitivity of U.S. energy supply and price to external shocks.

Recommendation No. 28: Maintain Agricultural Stockpiles

The bumper grain crop of 1981 and large carry-over stocks provide an opportunity for action to expand our program of grain reserves and so ensure stable prices for consumers and stable incomes for farmers in future years. The Department of Agriculture should be directed by the President to develop a proposal for maintaining national grain stockpiles at adequate levels. Sharp fluctuations in our food supplies could be reduced by pursuing a renewed bilateral purchase agreement with the Soviet Union.

Recommendation No. 29: Promote Competition, Not Cartels

The Reagan Administration has retreated from progress toward free competition in several vital transportation sectors.

The Interstate Commerce Commission, under Chairman Reese Taylor, has moved abruptly and dramatically to reinstall cartel-like restrictions on the trucking industry, to the detriment of independent truckers, shippers, and consumers. The President should give explicit guidance to the Interstate Commerce Commission that it return to a policy of free entry, free price-setting, and free competition in the trucking industry, consistent with the deregulation purposes of the Motor Carrier Act of 1980, and should take all necessary steps to ensure the installation of a pro-market majority on the Commission.

In the case of airlines, the Administration has also compromised the principles of free competition. International air carriers have been permitted to resume price-fixing negotiations at the International Air Transport Association, and domestic carriers have seen severe new restrictions on free entry in the domestic market for air routes. The Administration should move promptly to reassert the rule of the market in air transport.

In antitrust enforcement, the Administration has adopted a "bigger is beautiful" attitude which has encouraged marriages of the giants, further reducing the scope of competition in the economy, and exacerbating the diversion of scare capital resources away from longer-term, productive investment.

Recommendation No. 30: Productivity: The Private Sector Must Lead

The lead role in improving productivity must be assumed by the private sector. American business can and must take the lead in designing more efficient production processes, selecting and purchasing the most efficient equipment, and developing better worker-management relations and quality control.

We also reaffirm our suppport of the role government must play in promoting a higher rate of productivity growth. This role includes:

Economic policies which pursue economic growth, reduced inflation, full employment, and lower interest rates;

Tax incentives for saving, investment, and productivity growth;

Improved investment in public and private infrastructure;

Reduced anticompetitive economic regulation and Federal paperwork, cost-effective social regulation, and improved productivity in the Federal Government itself.

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G. International Economic Policy: Recommendations 31–34 160–169

Recommendation No. 31: Trade

The Administration's policy of tight money and high interest rates has led to an overvalued dollar, which has hurt U.S. exports, helped produce a sharp drop in our trade balance, and added to protectionist pressures.

The United States should press harder for more open international markets by accelerating the reduction in barriers to trade in high technology goods, pushing for international agreements on trade in international services, and reducing existing barriers to foreign direct investment. The United States should resist the temptation to transfer recession-bred unemployment to our trading partners with unfair trade restrictions. The United States should continue to facilitate the growth of U.S. exports, recognizing that the greatest progress in this area will come from a shift in economic policy fundamentals which encourages lower interest rates, worldwide economic growth, and a less overvalued dollar.

Recommendation No. 32: International Financial Institutions

The United States should continue to support the World Bank, the Regional Development Banks, and the International Monetary Fund. In many countries, the Development Banks and the IMF have helped build the capital and human infrastructure which are necessary preconditions for a thriving private sector. Furthermore, the activities of the Bank and the Fund have been consistent with long-term U.S. economic goals. The Administration should take the lead in working for a seventh replenishment of the International Development Association and the eventual expansion of IMF quotas.

Recommendation No. 33: Global Negotiations

At the 1981 Summit in Cancun, the Administration expressed a willingness to move forward with global negotiations on international economic questions. It is time for the Administration to come forward with some specific proposals and a timetable for the negotiations. The Administration should formulate a coherent policy to promote economic growth in the developing world. Its agenda should include measures to encourage trade with the developing world, an emphasis on shifting bilateral and multilateral assistance to the poorer of the development countries, and policies that will facilitate additional private-sector investment in developing economies.

Recommendation No. 34: East-West Trade

The Administration should develop a coherent policy concerning East-West commercial and financial relations. There is an urgent need for the development of a unified approach with our allies in West Europe and Japan.

H. Saving the Statistical System: Recommendations 35–36 171–174

Recommendation No. 35: Save the Statistical System

Recent budget cuts threaten the quality, coverage, and continuity of vital economic statistics. In most cases, greater attention to the maintenance of the statistical function could preserve data-gathering capability without significant increases in budget cost of burden on the public. We recommend that:

Further cuts in the budgets of the Bureau of Labor Statistics and Census Bureau not be made, since these cuts threaten the integrity or core economic data.

The Administration strengthen the statistical policy coordination function, either by providing it with strong leadership and increased staffing within OMB, of by establishing a separate Office of Statistical Policy outside OMB.

The Special Analysis of statistical policy in the President's budget, discontinued in 1979, be restored.

Recommendation No. 36: Needed: More and Better Information

The amount and quality of economic, social, industrial, and technological information available today are manifestly inadequate to the needs of

H. Saving the Statistical System—Continued Page

modern government, particularly for the formation of sensible economic, military, regulatory, industrial, and productivity policies. Moreover, failure to coordinate the use of existing data and economic models, coupled with political manipulation of key assumptions, has helped undermine the quality and the credibility of basic economic policy decisions, especially with respect to the budget.

Part III. Review of the Administration's Program for Achieving the Objectives of the Full Employment and Balanced Growth Act of 1978 and Review of the Current Services Budget 178
Part IV. Additional Views 182

AN ACTION PROGRAM FOR 1982

The Joint Economic Committee Democrats present here an action program consisting of two parts:

An immediate set of policies for the remaining months of the 97th Congress, designed to get us out of the recession and reduce the deficit;

A longer term program, work on which should start immediately, aimed at a revitalized America of sustained growth without inflation.

FIRST THINGS FIRST: GET US OUT OF THE RECESSION

This country is in a deep recession—the worst unemployment since the Depression, widespread business bankruptcy, great strains on our Federal system through the shortchanging of State and local government, large resources of people and goods wasted by stagnation, deficits dangerous and climbing, and the rest of the world badly hurt by our economic mismanagement.

The President and his administration ignore the recession. But, we, the Democratic Members of the Joint Economic Committee, believe that, in the months ahead, action *must* be taken to shorten the recession. The 97th Congress and the 1982 Fiscal Year both continue to next October.

Our immediate, short-term, 1982 action program to get us out of the recession follows. It is but a start of the long-term program that we need and recommend, but it is important to make that start.

It is a sensible program. It *is* achievable.

Specifically, for 1982, we recommend:

(1) *Emergency relief for the unemployed.*—Over 9.2 million men and women were unemployed in January 1982—more than in any year since the Great Depression. Yet, a smaller fraction are covered by unemployment insurance than in any recession since the 1960's, many are exhausting their protection, and in some States budget cutbacks have eliminated extended benefits altogether.

We recommend immediate action to assure that extended unemployment insurance, up to 39 weeks, is available in all 50 States, and to relieve the fiscal pressure on States which must borrow to keep their unemployment insurance benefit programs going.

(2) *Bring interest rates down.*—Interest rates can be brought down. We must:

(*a*) Stop the Administration and the Federal Reserve from further tightening money.

(*b*) Get deficits under control by creating deficit-reducing growth in the economy in 1982, and by adjusting future fiscal policy to produce much lower deficits just as soon as we have emerged from the recession.

(*c*) Practice credit conservation to minimize loans for commodity speculation and mergers, thus providing more credit, at lower interest rates, for small business, housing, agriculture, and productive capital investment.

Recommendations (*b*) and (*c*) both permit inflation and high interest rates to be fought with a less restrictive monetary policy, and hence with lower unemployment.

(3) *Change tax policy.*—Today, in the teeth of a recession, the Administration and Federal Reserve have announced a monetary policy that virtually ensures super-high interest rates for the foreseeable future. Equally perverse, on July 1, 1983, when the Administration proclaims that recovery will be underway, the tax decrease presently slated will go into effect and add to deficits and inflation. The remedy for this perverse fine-tuning is to defer the July 1, 1983, tax cut until we can determine whether it is needed. Indexing of the personal income tax to the Consumer Price Index due to take effect in 1985 should be repealed. Together, these actions should permit lower interest rates and recovery now while pointing the way to much lower deficits and inflation in the future.

A complete overhaul of our unfair and loophole-ridden tax system is necessary, but it is unrealistic to expect to accomplish much of this in 1982.

(4) *Hold the line on spending cuts.*—With only 73 percent of our economic capacity in use, the Administration favors further drastic expenditure cuts, both for 1982 and thereafter. These excessive cuts will deprive the economy of needed stimulus and the poor, the elderly, and the sick of desperately needed assistance. In addition, by short-changing State and local governments, they force them to turn to increases in regressive taxes which will deepen the recession. Congress should stand fast against the excessive social expenditure reductions which the Administration proposes for 1982 and for Fiscal Year 1983.

For the Future: Sustained Growth Without Inflation

Beyond 1982, the United States must turn to the task of achieving sustained economic growth and high employment without significant inflation. Past efforts to do this have been too narrowly limited to fiscal and monetary policies alone. These will not suffice. For 15 years, Administrations of both Parties have relied on them, with only one result: more frequent and sharper attacks of inflation and recession. The current Administration, wedded to a rigid economic ideology and to a destructive political agenda, has intensified these problems. This Report provides a blueprint which, if supported by vigorous national leadership and a popular will, could do the job.

Our recommendations are designed to meet the twin priorities of our agenda: to control inflation and to restore sustainable economic growth. Each requires many specific policy actions.

To Control Inflation

Our anti-inflation program is threefold. It does not rely exclusively on high interest rates, depressed demand, and recession, as does the anti-inflation policy of the Administration. It is therefore both a demand-side and a "supply-side" policy.

Monetary policy must be moderate, restrained, and designed to permit sustained economic growth, provided the goal of gradually reduced inflation is achieved.

Fiscal policy must act to close the Federal deficit rapidly as economic growth is restored. An immediate consequence of a more responsible long-range fiscal policy and a more moderate monetary policy should be lower interest rates, which will help immediately by reducing costs.

Finally, on the supply side, *incomes policy* can contribute to a coordinated reduction of inflation and inflationary expectations. Specific measures to stabilize food and energy supplies can contribute to restoring a general climate of price stability. Measures to promote competition and increase our rate of productivity growth can ensure that victory over inflation is maintained in future years.

TO RESTORE SUSTAINED GROWTH

Our program to restore sustained economic growth and high employment requires both a sensible macroeconomic policy and far-reaching structural reform.

The macroeconomic climate must foster growth by favoring investment in private, public, and human capital. That means lower and more stable interest rates, achieved by shifting the mix of monetary and fiscal policies, and an end to wasteful diversion of resources by the public sector, wherever found. At the same time, a fair tax and income security system must assure adequate living standards and purchasing power for the broad middle class and for working people, and so maintain the basic social consensus behind economic growth.

Structural reform is necessary in sector after sector throughout the economy to remove bottlenecks to growth, and to assure the competitiveness of U.S. industry with that of our major industrial rivals. Recommendations in this Report address all the major components of a structural reform agenda:

Our basic industries, and the workers and communities dependent on them, must adjust to the new international competitive situation.

Specific opportunities for growth and revitalization of the U.S. economy, such as the semiconductor industry and the coal industry, must be developed.

Public infrastructure must be maintained.

Civilian research and development must be fostered.

Labor must be trained.

If these efforts are undertaken by a determined Nation, led by a strong President and Congress, we are confident that the challenge of returning to sustained economic growth, high employment, and low inflation can be met and overcome.

Part I. REVIEW OF THE ADMINISTRATION'S ECONOMIC PROGRAM

A. THE ADMINISTRATION'S FORECASTS

The Administration's Forecasts

In February 1981, President Reagan presented his Economic Recovery Program to the Nation. This program had five parts, as outlined in the President's March 10, 1981, budget message:

(1) Cuts in Federal nondefense spending and increases in military spending.

(2) Personal and corporate tax cuts.

(3) Removal of excessive government regulation.

(4) Support for the Federal Reserve's policy of restrained monetary growth.

(5) Sure and predictable movement toward a balanced budget.

Congress passed the nondefense spending cuts and defense spending increases advocated by the President, with final approval of the first concurrent budget resolution for Fiscal Year 1982 in May. The President's tax program, as modified by Congress and approved by the President, was passed by both Houses of Congress in late July. The Administration proceeded within the first month to cut back regulations. And the Federal Reserve continued its tight-money policies, with Administration support.

We have not moved toward a balanced budget. In its March 1981 budget revision, for Fiscal Year 1982, the Administration projected budget deficits of $45 billion in Fiscal Year 1982, $22.8 billion in Fiscal Year 1983, and a surplus of $0.5 billion in Fiscal Year 1984. The Administration now estimates that the deficit will be $98.6 billion in Fiscal Year 1982, $91.5 billion in Fiscal Year 1983, and $82.9 billion in Fiscal Year 1984. The Congressional Budget Office baseline estimates, which do not include the vast new cuts in health care, pensions, cash assistance, and other social spending programs which the Administration is now proposing, project budget deficits of $109 billion in Fiscal Year 1982, $157 billion in Fiscal Year 1983, $188 billion in Fiscal Year 1984, and then above $200 billion in every subsequent year. These record deficits reflect the fact that the economy did not respond to the President's program as the Administration claimed it would, not any failure to enact the President's program. There were no outside shocks to the economy in 1981 from oil prices, food prices, import supply disruptions, or major foreign cyclical developments.

The results predicted by the Administration for the President's plan for 1981 and 1982 are summarized in Table I-1. As shown, the Administration predicted no recession, with strong growth picking up in late 1981 and continuing through 1982. After a slight initial rise, unemployment would fall to 7 percent by the end of 1982. Interest rates would fall. The Federal deficit would decrease. And inflation would fall.

We are currently in a serious recession, with real GNP falling at a 5.2 percent annual rate last quarter. The unemployment rate is now 8.5 percent. Interest rates rose sharply in mid-1981, with three-month Treasury bill rates approaching 17 percent in late May, then falling but rising again to nearly 16 percent in late August, and then falling until December, but now rising again.

TABLE I-1.—ADMINISTRATION ECONOMIC FORECASTS FOR 1981 AND 1982

Economic indicator	1981			1982		
	February forecast [1]	July forecast [2]	Actual	February 1981 forecast [1]	July 1981 forecast [2]	February 1982 forecast
Real GNP Growth: Fourth quarter to fourth quarter (percent)	1.4	2.5	0.7	5.2	5.2	3.0
Unemployment Rate: Fourth quarter average (percent)	7.7	7.7	8.4	7.0	7.0	8.4
Interest Rate: 91-day Treasury Bill average (percent)	11.1	13.6	14.1	8.9	10.5	11.7
Consumer Price Index: Fourth quarter to fourth quarter change (percent)	10.5	8.6	9.4	7.2	6.2	6.6
GNP Deflator: Fourth quarter to fourth quarter change (percent)	9.5	9.1	8.6	7.7	7.3	7.2
Fiscal year deficit (billions)	$54.5	$55.6	$57.9	$45.0	$42.5	$98.6

[1] "America's New Beginning: A Program for Economic Recovery," The White House, February 18, 1981, pp. 12, S-1.

[2] "Mid-session Review of the 1982 Budget," Office of Management and Budget, July 15, 1981, pp. 5-7.

[3] "Budget of the United States Government, Fiscal Year 1983," Office of Management and Budget, February 8, 1982, pp. 2-5, 9-62.

Inflation did fall in 1981, as predicted. In 1981, the rise in the Consumer Price Index was 8.9 percent, down 3.5 percentage points from the 12.4 percent rate of inflation in 1980. It is possible to disaggregate the drop in inflation into its major components. Such an exercise shows that, of the 3.5 percentage point decline, 0.6 points or 17 percent was due to a slower rate of inflation in energy; 1.1 points or 31 percent was due to a slower rate of inflation in food; and 1.5 points or 43 percent was due to a slower rise in the costs of homeownership. Slower energy inflation was the result primarily of a world recession, world oil glut, and the internal difficulties of OPEC; slower food inflation was a consequence of bountiful harvests. Only homeownership costs, which reflect the recession, can be attributed to the effects of the Administration's policy. Outside these three sectors, which account for 91 percent of the fall in inflation in 1981, inflation fell very little.

By mid-1981, the Administration realized that they had badly mispredicted interest rates. Thus, they raised their Treasury bill rate forecast by 2.5 percentage points, though the revised estimate still turned out to be too low. But implications of higher interest rates were not taken into account in revising the rest of the forecast. The estimate of real growth for 1981 was raised, and the estimate of real growth for 1982 was left unchanged. The fourth quarter unemployment rate estimates were left unchanged for both 1981 and 1982. And the forecast of the Fiscal Year 1982 deficit was actually reduced.

The most serious errors in the short-term forecast were made for 1982. This can be seen by comparing the Administration's February 1981 and February 1982 forecasts: in addition to the upward revision of the deficit, real growth is now predicted as 3.0 percent, compard to the 5.2 percent in last year's outlook; unemployment is seen averaging 8.4 percent in the fourth quarter, not 7.0 percent.

Clearly, the Administration's view of the short-term effects of the President's program was, with the exception of inflation, badly off the mark for 1981 and 1982. It is too early to reach a definitive evaluation of their forecasts for 1983 and 1984. But the track record for 1981 and the substantially less optimistic projections for growth, unemployment, and budget deficits in the Administration's latest forecast acknowledge that their earlier forecasts were too optimistic.

This inaccuracy in economic projections is reflected in the human tragedy of the recession: 708,000 more were on the unemployment rolls in the last quarter of 1981 than foreseen, with another 1.2 million discouraged workers; the housing industry is in a virtual depression, with starts last year of 1.09 million, the lowest since 1946; domestic auto sales were 6.2 million units, the lowest since 1961, when a General Motors strike hurt production; and interest rates have been on a roller coaster, up in the spring and summer, down in the fall, and up again since December. Congress might not have so readily eliminated ameliorative measures, such as the public service countercyclical employment program and the Economic Development Administration's depressed communities program, if it had known that we were entering a severe recession rather than an economic boom.

The Administration's Current Forecast for 1982 to 1986

The Administration's current forecast for 1982 is less unreasonable than it was in 1981. Table I-2 provides a comparison of the Administration's economic assumptions which underlie the Fiscal Year 1983 budget with the February 5, 1982, Congressional Budget Office baseline projections, and with the control forecast of Data Resources, Inc., presented in testimony to the Committee by Dr. Allen Sinai, Senior Vice President, on January 20, 1982. The table shows that the Administration projects real growth 0.9 percent higher, and average unemployment 0.3 points lower, than DRI. These differences are not dramatic; on the other hand, had the Administration used a more cautious economic forecast for 1982, its projected budget deficit would have exceeded $100 billion for Fiscal Year 1982.

TABLE I-2.—ECONOMIC FORECASTS, 1982-86

[Percent changes, unless noted]

	1982	1983	1984	1985	1986
Real GNP growth:					
Annual average:					
Administration	0.2	5.2	5.0	4.7	4.4
CBO baseline	−0.1	4.4	3.6	3.5	3.5
DRI	−0.7	4.1	3.5	4.7	3.7
GNP deflator:					
Administration	7.9	6.0	5.0	4.7	4.6
CBO baseline	7.5	7.3	6.6	6.0	5.7
DRI	7.5	7.7	7.2	8.4	7.3
CPI:					
Administration	7.3	6.0	4.6	4.8	4.6
CBO baseline	7.5	6.9	6.9	6.4	6.0
DRI	7.6	7.9	7.6	7.8	7.6
Unemployment (annual average):					
Administration	8.9	7.9	7.1	6.4	5.8
CBO baseline	8.9	8.0	7.4	7.2	6.9
DRI	9.2	8.3	7.6	7.0	6.6
91-Day T-Bill rate:					
Administration	11.7	10.5	9.5	8.5	7.0
CBO baseline	12.0	13.2	11.3	9.4	8.7
DRI	11.7	11.6	10.9	9.9	10.4
Budget deficit (fiscal year; dollars in billions):					
Administration	$98.6	$91.5	$82.9	$71.9	$66.0
CBO baseline	109.0	157.0	188.0	208.0	234.0

Sources: Fiscal year 1983 Budget, Feb. 8, 1982, pp. 2-5, 2-7, M-5. CBO, Feb. 5, 1982, Part I, p. XVIII.

For 1983 and beyond, the Administration continues to rely on optimistic economic projections, which have the effect of reducing the projected budget deficit in future years. Achievement of the Administration's optimistic real growth projections implies two things: sustained success against the inflation, and a willingness by the Federal Reserve to allow continued nominal GNP growth in excess of 9 percent per year. We doubt that, under current policies, sustained success against inflation will be achieved. And, under such circumstances, it is rash to assume that the Federal Reserve will permit renewed expansion of nominal GNP. It is, therefore, probable that we have not seen the last of the deluge of budget revisions and upward interest rate, unemployment, and deficit forecasts which have polluted public debate in the first year of the Reagan Administration.

With respect to inflation, there is no reason to accept the Administration's forecast of sustained success. The Administration projects a decline of inflation to a 4.7 percent rate by 1985, which may be compared with CBO's estimate of 6.0 percent and DRI's estimate of 8.4 percent for that year. The unrealism of the Administration's inflation estimate for 1985 is particularly important, since indexing of personal tax rates to inflation will begin that year. A more realistic inflation estimate is a key element in CBO's forecast of multihundred billion dollar deficits, due to indexing, for 1985 and beyond.

There is another dimension to the forecasting problem this year which has been completely overlooked by the Administration. We are currently in the second-dip of a "double-dip" recession, which occurred only a year after the short but severe decline of spring 1980. This recession, therefore, carries large risks and dangers not associated with previous recessions of a similar depth. Several large manufacturing corporations are flirting with collapse. The housing finance industry is in a deep crisis. State and local governments are experiencing some of the most severe fiscal problems of the post-war period, at a time when past service cutbacks are impairing their ability to provide minimum service levels and maintenance of infrastructure. According to Dunn and Bradstreet, small business bankruptcies are at a virtual post-war high; 17,043 in 1981, compared with a record of 17,075. Unemployment is at record levels, and unemployment insurance is not providing the protection it once did.

Under these circumstances, there is a significant risk not reflected in baseline econometric forecasts of a dramatic decline in economic performance in the months ahead. In his testimony on January 20, 1982, Dr. Sinai presented two such scenarios, to which he assigned a combined probability of 35 percent. Under the first, a deep recession occurs, followed by policy measures which bring about a recovery beginning in 1983. Under the second, Federal Reserve and Administration policies thwart the forces of recovery repeatedly for the indefinite future, leading to continued stagnation. The two scenarios, entitled "Deep Recession" and "Stagflation," are presented in Table I-3. We believe that Congress should take active account of major "downside" risks of the present situation, in moving rapidly to policies that will bring us back to economic growth, lower inflation and unemployment, and lower interest rates.

TABLE I-3.—DEEP RECESSION AND STAGFLATION SCENARIOS 1982-84

	Deep Recession (Prob. = 0.15)			Stagflation (Prob. = 0.25)		
	1982	1983	1984	1982	1983	1984
Real GNP	−3.2	5.6	5.4	−0.4	0.9	1.8
Consumption	−0.6	4.5	4.5	1.6	1.7	2.0
Nonres. Fixed Investment	−7.6	5.9	9.7	−0.7	−1.1	0.4
Federal Government Purchases	3.5	1.7	1.7	2.7	0.2	−0.1
State, local government purchases	−3.3	−1.5	1.1	−3.1	−1.2	−0.4
Exports	−3.3	6.2	7.4	−2.8	6.6	5.3
Imports	1.7	7.3	7.8	4.1	4.6	3.8
Prices and wages						
Consumer Price Index	6.6	5.9	6.7	7.9	8.3	8.5
Implicit price deflator	6.9	6.4	6.3	7.7	8.3	8.5
Interest Rates and Other Key Measures:						
Prime rate (percent)	14.20	12.71	11.37	17.24	17.30	17.06
New High-Gr. Corp. Bonds	12.90	12.04	11.66	16.01	16.69	16.28
Housing starts (millions)	1.07	1.66	1.96	1.09	0.99	1.22
Retail unit car sales (millions)	7.6	9.4	10.1	8.4	8.3	8.5
Saving rate (percent)	6.4	7.2	7.2	6.0	7.6	8.3
Unemployment Rate (percent)	10.1	9.5	7.8	9.0	9.1	9.1

Note.—In February 1982, DRI revised these scenarios and assigned a combined probability of 40 percent to them.

Source: Data Resources, Inc., "Review of the U.S. Economy," February 1982, pp. 1.147-1.148.

B. HIGH INTEREST RATES AND THE RECESSION

The recession of 1981 could and should have been avoided. It was man-made, in spite of the fact that past recessions have neither achieved a long-term reduction in inflation, nor laid a durable basis for renewed growth.

From the earliest days of the Reagan Administration, Members of the Joint Economic Committee warned that the economic program under development contained a grave internal contradiction. Monetary policy, according to the prescription laid down in December 1980, in the famous Stockman-Kemp memorandum, "Avoiding a GOP Economic Dunkirk," and later formalized in the Economic Recovery Program of February 18, 1981, was to become progressively more restrictive. But fiscal policy was to shift toward expansion, modestly at first, and then dramatically as later phases of the three-year personal income tax reduction and the military buildup took hold. The danger we saw was that, working at cross-purposes, these two principal macroeconomic instruments would drive interest rates up. And high interest rates would derail the Economic Recovery Program.

At our first hearing on the 1981 Economic Report of the President, which was held on January 22, 1981, the second full working day of the Reagan Administration, Chairman Reuss voiced this apprehension:

> I see that a major evil of the present economy, high interest rates, are likely under the Reagan program to be driven even higher than would otherwise be the case. Granted a part of the excessive interest rates in the recent past is due to inflation premiums. Granted, we do need monetary restraint as part of a comprehensive policy to reduce inflation. Still, present monetary policies, concurred in the Carter Administration, are apparently not tight enough—and interest rates thus not high enough—for the Reagan Administration.

> Moreover, the tax cuts which—if press reports are accurate—will soon be presented to the Congress will widen the budget deficit, increase Treasury borrowing, and thus drive interest rates even higher.

Numerous witnesses before the Committee in the early days confirmed and underscored our misgivings. The tax cuts, if enacted as proposed with the stated objective of restoring rapid economic growth, would add too much to consumption, too little to investment. The Federal Reserve had made clear its unwillingness to underwrite renewed economic expansion so long as inflation remained at intolerable levels. While it was conceivable that a comprehensive anti-inflation strategy which did not rely exclusively on tight money and high interest rates might permit a resolution of the dilemma and make possible the promised economic expansion, no such policy was proposed.

The danger of a possible credit crunch was recognized early in the year. On January 27, 1981, a supporter of the Administration's program, Charls E. Walker, made the point this way:

> So, even if the (tax and expenditure) proposals the Administration sends to Congress in mid-February are very solid from a supply-side standpoint, if the financial markets take a look at that and say Oh, my goodness, that is going to cause trouble, it can cause interest rates to go up very rapidly, and there could be a credit market crunch . . .

Other advocates of the Administration's program of sharply reduced taxes in combination with tight money defended their position to the Committee. Their view was that, if properly designed, the tax cut would unleash strong supply-side responses: more work, more savings, and more investments.

These responses would increase the supply of saving and tax revenues relative to what otherwise would be the case. Moreover, the conventional pressure of tight monetary policy on interest rates could be offset by a countervailing reduction in inflationary expectations, brought about because of the strong credibility of the President's monetary program. These two sets of forces, which were said to be not adequately taken into account in conventional economic analysis, would keep interest rates down. As Secretary Regan testified on February 19, 1981:

> All of the policies I have enunciated are mutually reinforcing. Spending cuts will release resources to the private sector, help balance the budget, and ease pressure on the Federal Reserve and the credit markets. Tax cuts will provide the necessary incentives and produce a savings surge. Reduced monetary growth will reduce inflation, and will restore confidence in financial markets and reinforce the strength and stability of the dollar in international markets. Deregulation will make a contribution to productivity improvements and will aid capital formation.
>
> The uniqueness of the President's program is in the long-term interaction of the program's components as a

package. These components can produce a framework for real economic prosperity and reduced inflation.

On February 23, 1981, Michael K. Evans provided the Committee with a strong statement of the "supply-side" view:

> The U.S. economy is about to enter a boom of major proportions beginning in the second half of this year if the Reagan tax and spending cut package is passed. Under this assumption, real GNP would increase at an average rate of better than 5 percent of the next eight quarters, the unemployment rate would fall to 5½ percent by mid-1983, and the rate of inflation would decline from its present level of 12 percent to the 8 or 9 percent range.
>
> The major factors which will propel the economy into this orbit will be supply-side oriented. While the Reagan tax cuts will stimulate the economy through raising consumption and investment, that is not the major thrust of the program. Instead, the factors that will permit this rapid rate of growth will be the expansion of the productive capacity of the economy through greater savings and productivity, rather than any increase in aggregate demand.

According to Evans, it was the distributional incidence of the Administration's tax cut proposal which gave it the property of stimulating savings more than consumption:

> If taxes were to be reduced in strict proportion to personal income without cutting tax rates—a 10 percent rebate for example—a $120 billion tax cut phased in equally over three years would generate only $24 billion in increased saving. Because Roth-Kemp is skewed toward middle- and upper-income taxpayers, the increase in saving generated by higher income alone will actually be $48 billion. Furthermore, the reduction in tax rates will increase the after-tax rate of return on saving sufficiently that personal saving will rise an additional $31 billion, yielding a total increase of $79 billion in 1983.

Coupled with the Administration's program of spending cuts, this increase in private saving would more than offset the rise in the public deficit, and so permit interest rates to fall. Evans continued:

> The odds of bringing the budget under control are much better than the financial markets presently perceive, and when this happens we will have a major change in psychology and further sharp reductions in interest rates.

Reduced inflationary expectations, brought into existence by the announcement of a credible anti-inflation, pro-growth policy, would form the second blade of the "supply-side" scissors. Like the effects of tax cuts on saving, these would make possible lower interest rates and improved growth despite the conventional Keynesian effect of the tax reduction which would tend to raise the budget deficit, boost effective demand, and push interest rates up.

The Director of the Office of Management and Budget, David Stockman, provided the Committee on February 20, 1981, with the clearest statement of the contribution to the Administration's success of a reversal of inflationary expectations which the Economic Recovery Program was intended to produce:

> The President's economic recovery plan seeks an immediate reversal of inflationary expectations by means of significant recodification of fiscal, regulatory, and monetary policy. Nothing is more essential to the success of the recovery plan than an immediate displacement of the inflationary psychology which currently dominates every form of American life.
>
> Reduction of inflationary expectations will improve the future value of the dollar and erode the future value of gold, commodities, and real assets. In these new circumstances, individual and institutional portfolio decisions will unlock savings that were previously stored in nonproductive tangible assets in order to preserve future value. With the moderation of inflation expectations, these savings will reflow toward productive financial assets. New incentives springing from tax rate reduction will enhance the real after-tax return on financial assets and will add to the savings formation process.
>
> The increased stock of savings will be available to finance the desired expansion of capital goods and plant and equipment necessary to sustain strong real output performance during the 1980's. Entrepreneurial business formation will be helped by the broadened availability of savings. Interest rates can decline as private-sector liquidity flows (rather than government-induced liquidity) combine with the general lowering of inflationary expectations.

In their appearances before the Committee, Administration witnesses tended to eschew precise forecasts that these supply-side and expectations effects would be felt at once. Indeed, as a group, they deliberately left unsettled the question of when the fruits of the President's program might be expected to be seen in the form of lower interest rates and renewed growth. The President might say, as he did in a message to the Congress on March 10, 1981, that Americans could look forward to immediate results:

> Our tax proposal will, if enacted, have an immediate impact on the economic vitality of the Nation, where even a slight improvement can produce dramatic results. For example, a 2 percent increase in economic growth will add $60 billion to our gross national product in one year alone.

The President's men, in their formal presentations, were considerably more cautious. Thus, the Administration's formal economic assumptions projected real growth of only 1.1 percent in 1981, and unemployment averaging 7.8 percent. Dr. Murray Weidenbaum, in his testimony of February 25, 1981, referred to a "1980–1981 period of weakness." Treasury Secretary Regan, on February 19, 1981, stated that:

> As a result of past developments, however, 1981 may be a sluggish year with overall growth of about 1 percent.

In response to a question by Chairman Reuss, Secretary Regan also stated that the Administration's assumptions and forecasts were based principally on subjective judgments, rather than on econometric evaluation in the conventional sense:

> Thus, there is not a single model nor a single set of multipliers which could be used to show the effects of our program. We do not believe than any model now available is able to capture fully the incentive effects of the very large changes in marginal after-tax rates of return on investment that we are proposing or the substantial effects on inflationary expectations that we foresee as the result of our program.

Nevertheless, it is clear that the selling point of the Administration's Economic Recovery Program to the Congress and the Nation was its anticipated early effect on real growth, productivity, investment, saving, and employment. As the White House stated in its message to Congress on February 18, 1981:

> The economic assumptions contained in this message may seem optimistic to some observers. Indeed, they do represent a dramatic departure from the trends of recent years—but so do the proposed policies. In fact, if each portion of this comprehensive economic program is put in place—quickly and completely—the economic environment could improve even more rapidly than envisioned in these assumptions.

At no time during our hearings did the Administration or its supporters suggest that their policies would lead to a sharp rise in interest rates, an unmanageable budget deficit, or a sharp recession and rise in unemployment above 8 percent in the fourth quarter of 1981. However, it is legitimate to question whether the Administration knew, or should have known, that these effects would occur.

The misgivings which Democrats on the Joint Economic Committee held about the Reagan program led us to recommend significant modifications in that program in our 1981 Annual Report. We proposed immediate actions to bring interest rates down, and a prudent, single-year tax reduction. Chairman Reuss summarized our views in his Introduction to the Report:

> (1) The Administration believes that the Federal Reserve should continue to lower its monetary targets in this critical year of 1981, while we oppose such action. Interest rates are too high now, and will remain too high if the Federal Reserve continues to tighten its monetary targets even though control over inflation has not been achieved. Excessively high interest rates will retard investment, growth, and control over Federal expenditure.
>
> (2) The destructive fiscal facet of the Administration's program is the proposed huge individual income tax cut, amounting to more than $140 billion per year when fully effective. The tax cut favors the affluent ($30,000 for a family earning $200,000, $385 for a family earning $15,000). The assertion that this radical tax cut will, by

> some trickle-down magic, produce full employment without inflation is simply not proved. Instead, we urge a moderate, cost-effective tax reduction to offset the payroll tax increase, and a depreciation tax cut followed by watchful waiting.

It was our view then, as now, that a strategy for renewed economic growth depends crucially on the economic vitality of small business, agriculture, housing, and productive capital investment. These, in turn, depend on a climate of reasonable interest rates. A balanced mix of moderate fiscal and monetary restraint seemed to us the best way to achieve this climate. We did not believe that the Administration's program provided a credible assurance that interest rates would fall rather than rise, and the events of 1981 amply confirmed our view.

The outline of events in 1981 is known to all. In February 1981, the President presented his economic program, which was radical in its declared intention to cut nonmilitary expenditure, in the magnitude of its intended military expansion, in the comprehensive character of its tax program, in its strong advocacy of a very restrictive monetary policy, and, not least, in the very strong and positive nature of the forecasts offered in its defense. In May and June, the Congress approved the President's requested budget cuts in the First Concurrent Budget Resolution and the Reconciliation Bill. In late July, Congress approved the President's tax program, with some modifications endorsed by the Administration. In October, November, and December, the Congress in the Second Budget Resolution and the appropriations process reaffirmed its approval of expenditure reductions and resource transfers requested by the Administration.

Yet, despite (or, indeed, because of) this success, the prime interest rate rose sharply from May until September. Under the relentless pressure of high interest rates, the stock market and the bond markets fell, providing early warning of investor unhappiness with the President's program. In the spring and early summer, housing and automobile sales disentegrated, reaching lows not seen for 15 or 20 years. Industries closely linked to housing and autos, such as applicances, lumber, steel, glass, rubber, and many others, began to feel the effects. The thrift institutions as a whole approached financial crisis. Small business bankruptcies rose 45 percent from rates a year ago. Real GNP fell in the second quarter, was maintained in the third quarter only by the continued accumulation of unsold inventories, and declined precipitously in the fourth quarter. Unemployment rose sharply in October, November, and December to 8.8 percent of the labor force, over 1.6 million more than in July, over 700,000 higher than the 7.7 percent fourth quarter unemployment rate the Administration had forecast in its mid-session review on July 15, and the highest number of unemployed persons since 1939. According to the McGraw-Hill survey, business investment plans for 1982 had fallen to near zero in real terms by the end of 1981. As a result of the recession, short-term interest rates did begin to fall in September and October, but a surge of distress borrowing at the end of the year drove them up again. Long-term rates remained too high to offer any realistic hope of providing strength to an early economic revival. None of the supply-side or expectations effects predicted by the Administraton or its supporters came to pass.

In retrospect, it seems clear that, while the outline of events in 1981 confirmed our early misgivings, the detail did not correspond precisely to the scenario we most feared. On balance, it was worse. The President modified his tax program from the February request, so that the personal income tax rate reductions would go into effect at a slower rate and in slightly smaller total amounts through 1983; in particular, the initial cut request was reduced from 10 percent to 5 percent and moved back from July 1, 1981, to October 1, 1981. By itself, this was clearly a wise decision. At the same time, however, the President endorsed, and Congress enacted, a vast array of additional tax reductions, including indexing of the personal income tax to the Consumer Price Index (CPI) after 1985, the most extravagant of several versions of depreciation reform, lease-back provisions permitting unprofitable firms to sell unused investment tax credits, near-total estate and gift tax elimination, and many other items. The effect was to greatly increase the total multi-year reductions in taxes and the size of the projected future deficit, making unattainable, among other things, the President's promise of a balanced budget in 1984. While the delay and reduction in the introduction of the 1981 personal tax cuts represented a modest tightening of fiscal policy relative to the original proposal in 1981, the vast increase in future tax reductions created the expectation of huge future deficits and so contributed to the pressure on long-term interest rates from July onward. There was probably no significant downward effect on interest rates from the modest short-run tightening of fiscal policy which the delay from July to October represented.

At the same time the Federal Reserve, with the Administration's unequivocal support, moved monetary policy in late spring to a posture sharply more restrictive than even the Administration had publicly requested only a few months before.[1] The consequence was extraordinary pressure on the entire term structure of interest rates. And the high interest rates of the summer and fall of 1981 led directly to the recession.

The shift of monetary policy to a sharply restrictive posture came in clear and complete contradiction of the principles of monetary policy endorsed before this Committee in early 1981 by both the Administration and the Federal Reserve. Every major official of the Administration and the Chairman of the Federal Reserve Board expressed to this Committee in 1981 a commitment to a gradual program of steady monetary restraint. In the President's Economic Recovery Program of February 18, 1981, this commitment was stated clearly:

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[1] The Administration's "Program for Economic Recovery" of February 18, 1981, states that ". . . the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986." In 1980, the rate of growth of M1B relative to 1979 was 7.3 percent. Thus, a reduction in M1B growth of 0.6 percent per year would have been sufficient to meet the Administration's objective, implying money growth of 6.7 percent in 1981, and declining to 4.5 percent in 1985. This 6.7 percent rate, which was never explicitly articulated by the Administration, was in fact higher than the top of the Federal Reserve's target ranges for 1981, which we also had criticized in our 1981 Report as too restrictive.

> If monetary policy is too expansive, then inflation in the years ahead will continue to accelerate and the Administration's economic program will be undermined. Inflationary psychology will intensify. Wages, prices, and interest rates will reflect the belief that inflation—and the destructive effects of inflation—will continue.
>
> By contrast, if monetary policy is unduly restrictive, a different set of problems arises, unnecessarily aggravating recession and unemployment. At times in the past, abruptly restrictive policies have prompted excessive reactions toward short-term monetary ease. As a result, frequent policy changes can send confusing signals, and the additional uncertainty undermines long-term investment decisions and economic growth.
>
> With money and credit undergoing steady, gradual reduction over a period of years, it will be possible to reduce inflation substantially and permanently. In this regard, the Administration supports the announced objective of the Federal Reserve to continue to seek gradual reduction in the growth of money and credit aggregates in the years ahead.

On February 19, 1981, Secretary Regan told the Committee:

> . . . we hope to assure a slow, steady growth in the money supply. With a problem successful in achieving a stable and moderate growth pattern for the money supply, both inflation and interest rates will recede, thereby restoring vigor to our financial institutions and markets.

On February 25, the Chairman of the Council of Economic Advisers, Murray Weidenbaum, gave the following view:

> . . . my monetarist friends . . . have, I think, taught us all the lesson that easy money, excessively rapid rates of growth in the money supply, ultimately generate high interest rates.
>
> On the other hand, the other extreme is destabilizing as well, as that the sort of moderate reduction in what has been an excessively high rate of growth in the money supply will contribute ultimately to lower inflation and lower interest rates.

On February 20, Budget Director Stockman described the Administration's program as including:

> A stable monetary policy to steadily reduce the growth of money and credit.

On April 8, 1981, Treasury Undersecretary Beryl Sprinkel gave the most detailed and precise presentation of the Administration's position that the Committee received:

> This Administration does not believe that monetary actions can be used effectively for short-run fine-tuning and will not press for monetary growth which causes more inflation. Instead, we share the Federal Reserve's objective of subduing the inflation tide, and we support their intent

> of achieving a permanently slower, noninflationary rate of monetary expansion . . .
>
> On the other hand, immediate, severe monetary restriction is not required, as some claim, to offset an alleged inflationary impact of the budget program. . . . We applaud and support wholeheartedly a long-term monetary program which will lead to a steady, predictable, and appropriately slow rate of monetary expansion.

And in his testimony on February 5, 1981, Chairman Volcker of the Federal Reserve Board indicated complete accord with a gradualist monetary program. He recognized in his testimony that a program of sharply tighter money, high interest rates, and recession could only lead to a temporary reduction in interest rates, an ephemeral gain which would be lost at once in the subsequent expansion:

> . . . our intention is over time to reduce money growth. . . .
>
> . . . in a sense the whole purpose and thrust of our policies, ironic as it may sound, is to bring interest rates down and it offers the best promise over a period of time that interest rates can come down. Interest rates will come down and stay down as the inflation rates get down. Interest rates may come down at any time if we run into a period of softness and business decline, but they won't stay down for that reason. They will only stay down when we have clearly turned the corner on inflation.

The Committee received, in short, a veritable deluge of monetary wisdom from the Administration and the Federal Reserve, and we urged the Administration and the Federal Reserve to adopt a gradualist approach, and particularly not to tighten money severely, in our 1981 Report:

> Monetary policy should be moderately restrained to reduce inflation while sustaining steady economic growth. The long-run rate of growth of money and credit is of primary importance, rather than temporary deviations from the long-run growth trajectory.

The contrast between the wisdom we received and the course of policy in 1981 is sharp and clear. Indeed, in 1981, the Federal Reserve and the Administration indulged in a classic overreaction to "temporary deviations from the long-run growth trajectory" of money. A sharp, one-time increase in money growth in March and April was sharply repressed, leading to a sharp rise in interest rates which began in May and which precipitated the recession.

In the first two months of 1981, the growth of M1B was slightly negative: shift-adjusted M1B fell from $415.6 billion in December 1980, to $415.5 billion in January 1981, and to $415.0 billion in February 1981. Then, in March and April, a "temporary deviation" of money growth from the long-run trajectory occurred: shift-adjusted M1B growth accelerated to 8.1 percent on an annual basis in March and to 16.4 percent in April. The proper response, as we had written only one month before in the Recommendation quoted above, would have been to wait and see whether underlying data reflected a change in real economic conditions, necessitating a change in policy, or whether a more normal situation would soon reestablish itself. Instead, in May, the Federal Reserve went cold turkey. Over the six months from April through October, M1B growth adjusted for shifts into checkable deposits from nondemand deposit sources was *negative.* Three-month Treasury bills jumped by over 2½ percentage points in response to the abrupt shift in policy in May. The prime rate followed, rising in May from 18 to 20.5 percent and staying at that level until September. The Dow-Jones Industrial Average, which had been above 1,000 in April, fell back in May, and continued to fall until September, when it averaged only 853.38. Domestic automobile sales slumped from an annual rate of 7.4 million units in the first quarter to 5.6 million in the second, and recovered only slightly in the third due to extensive rebate campaigns. Housing starts, which had stabilized at an annual rate of about 1.3 million units in February, March, and April, dropped in May to 1.15 million units and continued downward thereafter, reaching an annual rate of 867,000 units in October—a catastrophic level. There was, in short, nothing gradual or moderate about the course of monetary policy in 1981 or its consequences.

C. THE TAX PROGRAM AND INCOME DISTRIBUTION

Last year, in our Annual Report for 1981, we warned against economic policies which would worsen the distribution of income. Recommendation 14 of that Report states:

> The poor are threatened by proposed cutbacks in transfer programs, and the middle class has suffered a significant decline in its real income in recent years. Government tax and expenditure actions should not increase poverty or reduce the share of income going to the middle class.

At the time, we hoped for and recommended a tax policy that would, at a minimum, preserve the distribution of income then in existence and not redistribute income radically toward the top 5 or 10 percent of income receivers. We warned that, under the Kemp-Roth proposal, there would be strong tendency for just such a radical income redistribution.

The Administration adopted a policy diametrically opposed to our advice. The Economic Recovery Tax Act of 1981 was intentionally structured to provide much greater tax cuts for the wealthy than for the middle class. This was explicitly justified by the Administration on the hypothesis that such a skewed tax cut would stimulate savings and therefore investment. Treasury Secretary Donald Regan, in his testimony before the Committee on February 19, 1981, made this clear in the following colloquy with Congressman Richmond:

> Mr. RICHMOND. Now, as a businessman, if we want to get the economy moving again, would it occur to you and to the Administration and to everyone else that the quicker we reduce the taxes of lower income people, the

more stimulation that would be for the economy, rather than the higher income people?

Secretary REGAN. No, sir. It's just the opposite. The reason being that what we are looking for here, for the first time, is an income tax cut that is designed to stimulate both savings and investment, not consumption. As a result, where you'll have to put your emphasis is on that area of the taxpayers who would be most apt to save and invest.

Last year, the Committee and others seeking to analyze the effects on income distribution of the Administration's tax package were hampered by the weakness of available methods of measuring the relationship between tax policy and income distribution as the economy changes over extended periods of time.

The Committee engaged an independent consultant who worked with the econometric consulting firm of Data Resources, Inc., to bring to full development a new econometric model capable of estimating and projecting the characteristics of the income distribution over time. This study contains estimates of the distribution of income before and after taxes, the average tax rate for different income classes, and the shares of taxes paid, all by deciles of income receivers. Two situations were compared: the law as enacted in 1981, and the law as it would have been had the effective tax rates in effect in 1980 been simply kept in effect.[2]

The study demonstrates that the Administration's tax program accomplished a sharp redistribution of after-tax income toward the top 5 percent of income receivers, and a corresponding reduction in the share of total taxes paid by this group—those with an adjusted gross income (AGI) for joint returns of over $55,850 in 1980. The next 5 percent of income receivers, those with AGI's of between $44,540 and $55,850 in 1980, will also gain, but not as much. The next 40 percent will see virtually no change in their situtation relative to 1980 effective tax rates: for them, the 1981 tax "cut" represented nothing more than indexing of their brackets to inflation. The bottom 50 percent of taxpayers, all those in the broad middle class with adjusted gross incomes below $22,610 in 1980, will see their effective tax rates rise relative to 1980 levels under the Administration's tax law, and their share of after-tax income will fall.

The study shows that, while expected economic growth will increase the share of income earned by the upper middle class and reduce that of the top 5 percent of joint taxpayers, the massive tax cut given to that top 5 percent will reduce their share of taxes paid enough to raise their share of after-tax income. This top 5 percent of joint taxpayers, who reported adjusted gross incomes of over $55,850 in 1980, will see their average tax rate decline 3.5 percentage points from 26.6 percent in 1980 to 23.1 percent in 1985, and a further 2 percentage points to 21.1 percent in 1990. Their average savings, compared with what they would have paid if their average tax rate had remained unchanged from 1980, will be over $4,000 in 1985 and over $9,000 by 1990.

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[2] This assumption is superior to the alternative assumption that the specific provisions of the 1980 tax law be kept in effect, since those provisions would have implied a rising tax burden on constant real incomes over time due to bracket creep and inflation, and since Congress has historically always adjusted tax brackets to offset such bracket creep approximately. For further detail, see "The Impact of the 1981 Personal Income Tax Reductions on Income Distribution," Joint Economic Committee, December 23, 1981.

The 5 percent of joint taxpayers who reported 1980 adjusted gross incomes between $44,540 and $55,850 will see their average tax rate decline 2.4 percentage points from 21.4 percent in 1980 to 19 percent in 1985, and then rise half a percent to 19.5 percent in 1990. Their before-tax share of AGI is expected to be a constant 9.6 percent throughout the period, and their after-tax share increases only insignificantly. Their share of total taxes paid will decline slightly by 1985, but more than half of the decline will be made up by 1990. The average savings they realize from paying taxes at 1985 rates instead of 1980 rates will be about $1,800, less than half the savings of the top 5 percent. By 1990, their average tax savings will have grown only 13.5 percent.

The 40 percent of joint taxpayers who reported adjusted gross incomes in 1980 of between $22,610 and $44,540, who receive a bit less than half the total income reported on joint tax returns and pay a slightly smaller share of taxes, will see little change in their situation. Their share of before-tax AGI is expected to increase by about seven-tenths of a percent by 1985, and to remain higher. Their share of total taxes will increase throughout the period, so that their share of after-tax AGI is higher in 1985, but back to about the 1980 level by 1990. Their average effective tax rate declines slightly by 1985, but then increases. Their average tax saving from the reduction in effective rates is $210 in 1985 and $58 in 1990.

The bottom half of the joint taxpayers, those who reported adjusted gross incomes below $22,610 in 1980, are expected to see their shares of both before- and after-tax AGI decline throughout the period, with the result that both their average effective tax rate share of taxes paid will rise.

The results of the study are summarized in Tables I-4 and I-5.

TABLE I-4.—THE EFFECTS OF THE ECONOMIC RECOVERY TAX ACT OF 1981 ON THE DISTRIBUTION OF INCOME AND TAXES PAID BY TAXPAYERS FILING JOINT RETURNS

Percent of joint taxpayers, range of 1980 adjusted gross income	Lowest 50 pct., under $22,610	Next 40 pct., $22,610 to $44,540	Next 5 pct., $44,540 to $55,850	Top 5 pct., over $55,850
Percent of AGI:				
1980	25.8	48.6	9.6	16.0
1985	25.5	49.3	9.6	15.7
1990	25.4	49.2	9.6	15.7
Percent of total tax paid:				
1980	13.2	47.6	12.7	26.4
1985	14.8	49.6	12.0	23.6
1990	14.8	50.9	12.4	21.9
Percent of after-tax AGI:				
1980	28.2	48.8	9.0	14.0
1985	27.5	49.4	9.2	14.1
1990	27.3	48.9	9.1	14.6
Average effective tax rates (percent):				
1980	8.3	15.7	21.4	26.6
1985	8.8	15.3	19.0	23.1
1990	8.7	15.6	19.5	21.1

Note.—Rows may not add to 100 due to rounding.

Source: "The Impact of the 1981 Personal Income Tax Reductions on Income Distribution," Joint Economic Committee, December 23, 1981.

TABLE I-5.—COMPARISON OF AVERAGE TAXES PAID IN 1985 AND 1990 WITH AVERAGE TAXES IN THOSE YEARS IF THE EFFECTIVE RATES OF 1980 HAD APPLIED; TAXPAYERS FILING JOINT RETURNS

Percent of joint taxpayers, range of 1980 adjusted gross income	Lowest 50 pct., under $22,610	Next 40 pct., $22,610 to $44,540	Next 5 pct., $44,540 to $55,850	Top 5 pct., over $55,850
1985				
Actual average tax	1,772	7,443	14,336	28,226
Average tax at the 1980 effective date	1,771	7,653	16,213	32,536
Difference	+1	−210	−1,847	−4,310
1990				
Actual average tax	2,590	11,191	21,838	30,169
Average tax at the 1980 effective rate	2,456	11,249	23,935	39,202
Difference	+134	−58	−2,097	−9,033

Note.—These hypothetical taxes are estimated using the average tax rate, not the actual tax code in effect in 1980. Thus, they imply the elimination of all bracket creep (from either inflation or real growth) with no other change in the tax system.

Source: "The Impact of the 1981 Personal Income Tax Reductions on Income Distribution," Joint Economic Committee, December 23, 1981.

There is evidence of another type which casts light on the association between inequality and economic growth. This is derived from the experience of various countries, with differing degrees of inequality and rates of growth. Were the "trickle-down" theory valid, countries with high inequality would show rapid growth, while those with less inequality would be more nearly stagnant.

Analysis of the leading industrial democracies not only fails to confirm this high inequality/high growth hypothesis, it shows just the opposite. Those countries with above average inequality have grown less rapidly than the more nearly equal countries.

A study several years ago for the Organization for Economic Cooperation and Development (OECD) compared the income distributions of most OECD countries.[3] The relative rankings of the countries differed somewhat, depending on the measure used and the choice of income concept. But the results indicated that, of the 12 countries analyzed, the United States in the early 1970's either had the greatest degree of inequality or was second only to France. The United Kingdom, Sweden, and, especially, Japan all exhibited much less inequality than the United States. Focusing specifically on the lower end of the distribution, the poorest 20 percent had a lower income share in the United States than in any of the other countries on a pre-tax basis, and were second to France on a post-tax basis. However measured, the results clearly showed that we had one of the most unequal distributions, and this did not take into account the deterioration in income shares received by the second- and third-fifths of the population since the early 1970's, discussed below.

Most of the discussion of our inadequate productivity growth has focused on the slowdowns since the late 1960's an early 1970's. This has masked the fact that even prior to then our growth rate was less than that of most other industrialized countries. Between 1960 and 1973, our labor productivity growth rate was 3.1 percent per year—three times the subsequent 1.1 percent rate between 1973 and 1979, but less than the 1960 to 1973 rates for Japan (9.9 percent), Italy (7.8 percent), Belgium (6.1 percent), France (5.9 percent), West Germany (5.8 percent), Sweden (5.8 percent), Canada (4.2 percent), and the United Kingdom (3.8 percent). All of these countries had slower growth between 1973 and 1979 than between 1960 and 1973, but since we grew less rapidly in the earlier period, our relative position continued to deteriorate. For the 1960 to 1979 period as a whole, our labor productivity growth rate was less than one-third of Japan's, and less than half those of Italy, Belgium, France, and West Germany.

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[3] Malcolm Sawyer, "Income Distribution in OECD Countries," July 1976, OECD, Paris.

The simple facts are that the United States is at or near the top of the inequality list and Japan is at the bottom, while we have had the lowest productivity growth rate and the Japanese have had the highest. Of course, such a two-country comparison, while revealing, is not conclusive, because the experience of other countries should be taken into account, and many factors affect growth besides income distribution.

As shown in Table I-6, overall there is clearly a strong inverse relation between income inequality and labor productivity growth. Comparing the United States with Japan, West Germany, and Canada, our three largest trading partners, we find that by Measure I: Japan had the lowest inequality and the highest productivity growth; West Germany had the second lowest inequality and the second highest productivity growth; Canada had the third lowest inequality and the third highest productivity growth; and the United States had the highest inequality and the lowest productivity growth.

TABLE I-6.—INCOME INEQUALITY AND PRODUCTIVITY GROWTH RATES

Relative index of income inequality, 1970–75 (U.S. = 100)			Average labor productivity growth rate, 1960–79 (percent)
Country	Measure I	Measure II	
United States	100	100	2.5
Canada	94	95	3.2
France	92	103	5.4
West Germany	68	98	5.3
United Kingdom	65	85	3.2
Sweden	63	86	4.7
Japan	48	83	7.9

Source: OECD, Joint Economic Committee.

Similarly, on balance, countries in which the lowest fifth of households have a low share of income have had the poorest productivity growth rates. The comparison between the United States and Japan (twice our income share for the bottom 20 percent, more than three times our productivity growth rate) is again striking.

Thus, looking at a cross-section of the leading industrialized countries, there is no evidence to support the "trickle-down economics" school of thought. The facts indicate that, in high growth economies, income doesn't "trickle-down" over time, but is distributed more nearly equally than in the United States in the first place.

The Administration has embarked on a set of policies which can only increase inequality. As expressed by 1981 Nobel Laureate James Tobin, "Wealth and power are to be redistributed to the wealthy and powerful."[4] These policies have been undertaken in an attempt to stimulate growth. Before proceeding further, the proponents of the Administration's "trickle-down" theory should look abroad, and they will realize that our allies who have had the highest growth rates also have had the least inequality.

D. The Defense Buildup and Inflation

The defense buildup proposed by the Administration is the largest in our peacetime history. During 1981 to 1987, the defense budget is scheduled to rise from $160 billion to $364 billion. The annual rate of increase is estimated at about 7.5 percent in real terms. Defense budget authority increased by 34 percent during Fiscal Years 1965 to 1968. In Fiscal Years 1981 to 1984 defense budget authority will increase by nearly 30 percent.

The buildup is comparable in important respects to the one that occurred during the Vietnam period. Relative to GNP, the Vietnam buildup was larger and more rapid. Defense rose as a share of GNP from 7.2 percent to 8.8 percent in the period 1965 to 1967. In the period 1981 to 1985, the defense share of GNP will rise from 5.6 percent to about 7 percent.

The increases for procurement are more nearly equal. Real budget authority for defense purchases increased by about 9 percent per year during 1965 to 1967, slightly below the rate estimated for 1981 to 1985. This comparison is important because the present buildup is concentrated in defense purchases while during Vietnam there was a balanced expansion of purchases and manpower. Most of the direct economic effects of the defense buildup will be on the defense industries.

Although the estimates of future defense spending are quite high, they are probably understated. The reasons for the understatement have to do with assumptions about future inflation. In making its estimates of future defense spending, the Office of Management and Budget assumes that there will be less inflation in the defense sector than should be assumed by historical standards. All estimates of future government spending are based in part on estimates about future inflation. OMB's error is in assuming that the inflation rate in the defense sector will be the same as inflation in the general economy.

Several years ago, the Joint Economic Committee helped initiate a program designed to break out inflation in the defense sector from inflation in the general economy. This effort culminated in the development of a defense deflator by the Bureau of Economic Analysis of the Department of Commerce. The defense deflator, which is based on information about actual defense prices derived from tens of thousands of defense purchases, shows the level of price changes in the defense sector. It is a part of the National

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[4] James Tobin, "Sleight of Mind," New Republic, March 21, 1981, p. 13.

Income and Product Accounts and is published monthly in the *Survey of Current Business.*

Inflation in the defense sector, as indicated by the defense deflator, has exceeded inflation in the general economy every year since 1975, with the exception of 1979. The difference between inflation in the defense sector and inflation in the general economy is illustrated in Table I-7 which compares the DOD deflator with the GNP deflator.

TABLE I-7.—DOD AND GNP PRICE DEFLATORS ANNUAL RATES OF CHANGE

[Fiscal years, percentage changes from previous year]

Year	DOD deflator	GNP deflator
1975	12.5	10.8
1976	8.8	6.9
1977	8.5	5.6
1978	8.5	6.8
1979	8.0	8.7
1980	14.6	9.2
1981	13.4	9.9

Note.—DOD Deflator excludes compensation.

Source: Data Resources, Inc.

By using the lower estimate of inflation, based on the GNP deflator rather than the DOD deflator, the Administration has opened up what may be termed a defense inflation gap. This is the difference between what defense spending is likely to be under realistic assumptions about inflation in the defense sector, and the official OMB estimates. This gap is projected to be as high as $80 billion for Fiscal Years 1983 to 1987. That is, assuming inflation in the defense sector consistent with the DOD deflator for recent years, it will cost about $80 billion above the level of current defense spending estimates to purchase the same amount of goods and services assumed by the Administration's budget.

In discussing this matter during hearings before the Subcommittee on Economic Goals and Intergovernmental Policy in 1981, spokesmen for the Administration readily conceded that inflation has been higher in the defense sector than in the general economy and that current estimates of the actual costs of the defense buildup are too low. The major argument for continuing to use the same inflation estimates for all portions of the government's budget appears to be that using a higher inflation estimate for one portion of the budget, such as defense, would transform the higher estimate into a self-fulfilling prophesy. Implicit in this argument is the idea that using a lower estimate will help prevent inflation in the defense sector from going higher.

We reject this argument as incorrect and unrealistic. Using inflation assumptions that are too low by historical standards has had no deterrent affect on defense inflation in the past and is not likely to be a deterrent in the future. The same can be said about assumptions about inflation in the general economy, which also are frequently unrealistically low. Unrealistic inflation assumptions are damaging because, when actual costs exceed budget estimates due to inflation rates that are higher than anticipated, defense officials must either curtail or stretch out programs or request supplemental appropriations. Partly as a result of this unrealistic approach to defense spending estimates, a number of defense programs in recent years have been curtailed, stretched out, or canceled. This increases defense costs in the long run and has adversely affected efforts to improve readiness, the spare parts inventory, and the level of training.

In the Fiscal Year 1983 budget proposals, a portion of the estimated defense costs assume inflation rates somewhat higher than in the general economy. This is a step in the right direction.

Possible Inflationary Effects

The size and rapid pace of the defense buildup have led to a fear among experts (in defense economics) that the buildup will add significantly to inflation in the general economy. This conclusion is partly based on a comparison of the present buildup with the one that occurred during the Vietnam period. Economist James R. Capra testified that the stimulus to aggregate demand from defense spending will mean "a higher inflation rate for the next few years than would be the case without the defense buildup, even if the Federal Reserve were not to accommodate the extra government spending."

The Administration disputes these contentions. Murray L. Weidenbaum, Chairman of the President's Council of Economic Advisers, testified that what made spending inflationary during the Vietnam war was not that the funds were used to purchase weapons and manpower for the war effort, but that the level of spending was not reduced elsewhere, and that monetary policy was deliberately expansionary. Chairman Weidenbaum said that the Vietnam buildup was inflationary because it involved a surprise, sudden shift in the pattern of resource utilization, and because it was accompanied by an increase in monetary policy. The defense spending surge led to short-term inefficiencies and higher prices in the defense sector, while the expansionary fiscal and monetary policy produced a longer term inflationary problem.

The Administration believes that the present buildup is not an unplanned surprise or sudden surge, but rather a gradual planned buildup over several years. The Administration also argues that, while the defense spending increases are very large, they are too small a proportion of the gross national product to create inflationary pressures by stimulating excess demand. This is especially the case in a period such as the present one of low capacity utilization. According to this line of reasoning, there is sufficient excess capacity to absorb additional defense spending because the economy is operating well below its potential in terms of both manufacturing capacity utilization and unemployment.

The Administration's argument that the present buildup does not involve a sudden shift of resources, as occurred during the Vietnam period, is borne out if the changes in defense spending are compared with the GNP. Defense spending increased from 6.9 percent in 1965 to 9.3 percent of GNP in 1968. Under the present buildup, defense spending will increase from 5.2 percent in 1980 to only 7 percent in 1986.

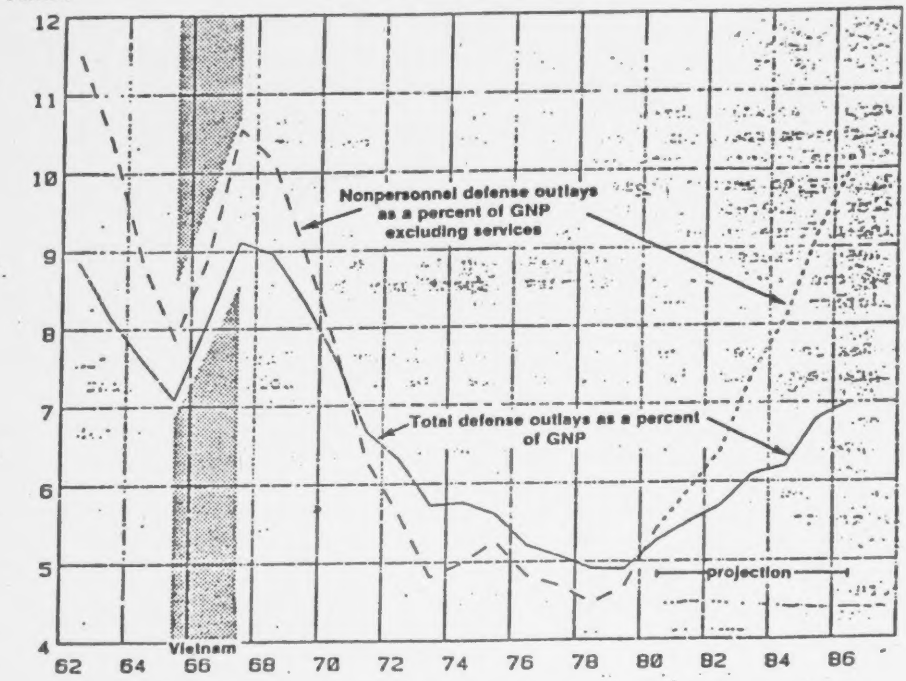
However, the rise in procurement spending will be greater under the present buildup than was the case during Vietnam. In 1965 to 1968, procurement increased from 7.9 percent of the manufacturing base to 10.6 percent. In 1980 to 1986, procurement will increase from 5.4 percent of the manufacturing base to 10 percent.

This comparison is important because the two buildups differ in composition. During the earlier one, there was a surge of spending for manpower as well as procurement and the effects of that spending were felt throughout the economy. The present buildup enphasizes procurement and the effects of that kind of spending will be concentrated in the manufacturing sector. There will be a surge in defense spending as far as the manufacturing sector is concerned. The issue is, can industry respond quickly and smoothly to the procurement surge without exerting inflationary pressures on the economy?

Chart I-1, prepared by Dr. Gary Wenglowski and submitted to the Committee, compares the procurement (nonpersonnel defense outlays) as a percent of the manufacturing base (GNP excluding services) during the Vietnam and the present buildup. The surges in procurement leads Dr. Wenglowski to conclude, "The rise in defense spending planned by the Reagan Administration is likely to put more inflationary pressure on the economy than many of the conventional analyses have indicated."

Chart I-1

Defense as a Percent of GNP



Source: Office of Management & Budget, Bureau of Economic Analysis, Goldman Sachs estimates

The facts suggest the buildup will likely add to inflation only slightly if at all in the short term. As Alice M. Rivlin, Director of the Congressional Budget Office, testified, the margin of idle capacity currently in the economy can accomodate noninflationary growth. The more difficult question is whether the defense buildup will become inflationary when the economy recovers from the present recession and enters a period of growth.

Director Rivlin testified that the buildup will become inflationary as the economy moves toward full employment of resources unless there are offsetting cuts in nondefense spending, tax increases, or "counterbalancing" monetary policy. This conclusion is supported by econometric simulations of defense spending increases comparable to the present buildup. These simulations show that defense increases are not inflationary provided they are offset by a combination of comparable tax increases and nondefense spending cuts. The available evidence demonstrates that we can afford defense spending increases provided we pay for them.

Unfortunately, the defense buildup will not be paid for or financed under the present course of fiscal policy. The tax cuts enacted in 1981 will reduce Federal revenues by approximately $750 billion over the next five years. These reduced revenues when added to the increases in defense spending will overwhelm the reductions in nondefense programs. Assuming the economy enters a period of sustained economic growth and approaches full employment of resources, the defense buildup will be inflationary unless there are large reductions in nondefense spending or increases in taxes. To date, the Administration has not made proposals to demonstrate that such offsetting initiatives will be taken.

Bottlenecks

Testimony received by the Subcommittee also indicated that our understanding of capacity utilization is incomplete and that the statistics may be misleading with respect to the defense sector. Because capacity utilization data are collected on an aggregated basis, it is possible for the statistics to show low utilization for industry as a whole, while critical sectors of industry are operating near or at full capacity. The same problem exists with respect to the labor market. Overall unemployment may be high while there are shortages of critical skills.

Lester Thurow testified that the stagnation experienced in the American economy over the past three years has been a mixture of boom and depression. While States such as Texas, California, Florida, and Massachusetts, and industries such as semiconductors and computers, have been booming, the industrial mid-west and the steel and automobile industries have been in the midst of a depression. Thus, while there has been general idle capacity of both workers and equipment, it is concentrated in a few regions and industries. But the industries and regions where idle capacity exists are not those where military equipment is purchased. As a result, the defense buildup is likely to exacerbate both the shortages of resources in the high technology and defense industrial sectors, and the regional imbalances in the national economy.

The Administration believes that the defense buildup will not create industrial bottlenecks because the increase in military procurement can be anticipated by defense firms who will increase their capacity and production as demand rises. Statistics relating to some of the major industries involved in defense production lend some support to the Administration's position. Capacity appears to be adequate for the near term in primary metals, aerospace, shipbuilding, electronics, and construction. The backlogs of orders and manufacturing lead times for certain components used in defense production have also declined somewhat recently.

On the other hand, Charles L. Schultze analyzed the effects of the defense buildup on the manufacturing base and came to the "rather startling conclusion that some 30 percent of the increase in the 'goods producing' GNP over the next four years will go to the military." Dr. Schultze concluded from this that the buildup will create a bottleneck problem in the defense industries.

An analysis performed by George F. Brown, Jr., based on an input-output matrix developed at Data Resources, Inc., identifies a number of large, key defense industries where bottlenecks could occur. In these industries, production will have to be increased to unprecedented levels by 1986, 30 percent or more above the peak levels previously achieved by those industries. Among this group are the aircraft engine, semiconductor, guided missile, and electronic computer industries.

There is also mounting evidence that a bottleneck problem in certain areas of the defense industry already exist and that it will intensify under the buildup. Jacques Gansler and Gail Garfield Schwartz testified that bottlenecks are present at the lower tiers of the defense industry, among smaller prime contractors, subcontractors, and parts suppliers. Dr. Gansler stated that lengthy delivery delays of major weapons have been driven by lead time increases among five groups of components common to aerospace systems and supplied by small and medium sized firms: bearings, castings, connectors, forgings, and integrated circuits. The reasons for the long lead times in these areas are lack of supplier capacity, shortages of production equipment, much of which is old and insufficient, shortages of materials such as molybdenum and titanium, and shortages of skilled labor.

Dr. Gansler's studies confirm other reports of significant shortages in many defense-related labor categories including aerospace and computer engineers, machinists, and tool and dyemakers. The labor shortages are expected to grow worse as the aging defense workforce phases out because of the long-term training and education required to produce replacements.

The lack of capacity among the smaller firms is especially troublesome because these firms face serious obstacles in expanding capacity. Due to limited ability to raise equity capital, they rely heavily on debt financing which has become nearly prohibitive because of high interest rates. The recent downward trend of interest rates is a mixed blessing for small firms as the recession and weakening demand responsible for the decline in interest rates increase the chances of bankruptcy. It is also difficult for the smaller firms to compete with the larger ones for skilled workers.

Charles L. Schultze testified that the heavy emphasis on procurement and the rapid pace of the defense buildup will not only create bottlenecks in the defense industries, and shortages of skilled labor and specialized components, but also strain the capacity for managerial oversight. Official confirmation of the bottleneck problem came from Assistant Defense Secretary Jack R. Borsting who testified:

> There likely will be certain areas where current bottlenecks in the defense industry will occur; where inflation may continue at a higher rate than in the nondefense sector; and where competition for skilled technicians will be intense.

The bottleneck problem is a serious problem for two principal reasons. First, bottlenecks are a major contributing cause of cost overruns in defense procurement. The Joint Economic Committee has held numerous hearings into the causes and consequences of defense cost overruns. Hearings conducted in 1981 concerning the M-1 tank and the MX missile, together with other evidence, demonstrate that cost overruns are a continuing problem.

The Subcommittee received testimony that unit costs for major defense weapon systems have increased recently across the board. Table I-8 shows the cost increases since January 1980 for 37 major defense systems. As can be seen from the table, many of the cost increases have been dramatic and startling.

TABLE I-8.—PROJECTED FISCAL YEAR 1982 UNIT COSTS OF MAJOR WEAPON SYSTEMS, JANUARY 1980 ESTIMATE COMPARED TO MARCH 1981

[Dollars in millions]

	January 1980 estimate	March 1981 estimate	Percent of change
Army systems:			
AH-64	$25.81	$29.70	+15
UH-60	3.71	5.54	+49
Roland	0.41	0.60	+48
Patriot	1.47	2.26	+53
Hellfire	0.04	0.12	+167
Pershing II	4.25	4.92	+16
MLRS	0.06	0.07	+19
Fighting vehicle	0.90	1.35	+49
M-1 tank	1.39	2.44	+76
Divad	4.18	5.86	+40
Navy systems:			
F-14	33.50	34.48	+3
F-18	22.38	32.01	+43
SH60B	27.10	38.37	+42
P3C	33.49	35.59	+6
E2C	36.95	41.02	+11
SH2F	11.36	12.91	+14
EC130Q	30.25	37.45	+24
Trident I	10.34	10.88	+5
Sparrow	0.13	0.16	+22
Phoenix	1.50	2.03	+36
Harpoon	0.78	0.83	+7
Harm	0.51	0.80	+58
SN-688	517.50	581.80	+12
CG-47	896.40	1,018.20	+14
FFG-7	278.73	323.97	+16
MCM	87.30	99.70	+14
Tagos	37.65	39.13	+4
Air Force systems:			
A-10	8.66	10.40	+20
F-15	28.02	29.33	+5
F-16	11.53	12.96	+12
KC10	49.33	54.63	+11
E3A	114.35	118.00	+3
ALCM	1.06	1.34	+26
GLCM	4.20	5.80	+38
Sparrow	0.12	0.15	+19
Harm	0.45	0.66	+44
Maverick	0.39	0.47	+21

The bottleneck problem can undermine the primary purpose of the defense buildup by escalating the costs of weapons. Although the Administration is determined to maintain the present planned real increase in defense spending, if current trends in unit cost increases continue, it is likely that decisions will have to be made to either reduce procurement quantities or reduce funds for operations and maintenance or other activities that have a direct bearing on military readiness. As James R. Capra testified, "Unless something is done about weapon system cost growth, the United States in the 1980's may be paying more for defense but buying less."

The second reason the bottleneck problem is important concerns the spillover effects from the defense industry to nondefense industries and to the general economy. Spillover effects can occur with respect to shortages of materials, components, production equipment, and skilled manpower. These effects can influence price levels and the availability of supplies in the civilian sector as well as the competitiveness of civilian industries in world markets.

As the buildup proceeds, it is likely that equipment, materials, components, and skilled workers in short supply will have to be transferred from civilian to defense industries. As Professor Thurow testified, this will cause civilian production to fall and lead to civilian price increases because of the smaller available supplies among civilian users. In addition, high permiums will have to be paid by defense firms to attract the physical resources and workers out of civilian firms. This will raise wages, materials costs, and the prices of intermediate products used in both defense and civilian firms.

This process will create obstacles for American high technology firms not faced by their foreign competitors whose governments are not engaged in major defense buildups. American firms producing civilian goods will be weakened by this shift of resources to defense production. Foreign firms will not be hampered in the same way and therefore will enjoy a relative advantage.

Inadequate Information Base

Some of the problems concerning the adequacy of information about the defense sector have already been noted. The information available to analysts and policymakers is inadequate for a full understanding of current conditions in the defense industries or in sectors of the economy that span defense and civilian industries such as labor markets. The information gaps make it impossible for the government to monitor and accurately forecast the effects of the defense buildup on the defense industry or on the general economy.

For example, the statistical series concerning capacity utilization in the manufacturing industries are at too high a level of aggregation to permit an analysis of capacity utilization in critical areas of the defense industries such as small and medium sized suppliers. Credible data about capacity among firms producing specialty items and other detailed sectors do not exist.

Little is known about the demand for and the supply of many categories of skilled labor. Under the present state of knowledge, it is impossible to forecast whether the future supply of scientists, engineers, and skilled craft workers needed because of increased defense requirements will increase fast enough to prevent shortages before they cause price increases or delivery delays.

Little is known about the likely response of defense firms to increased defense demand. One of the Administration's underlying assumptions is that defense firms will increase investment as demand increases and that new firms will enter the growing defense market. However, defense specialists note that the practice has been for defense contractors to add to their backlogs during the boom portion of the defense business cycle in order to protect themselves against the downward swing. Good data about defense business investment behavior and whether it differs for defense prime contractors and lower tier contractors do not exist.

There is insufficient information to fully understand the response of the economy with respect to the supply of labor, parts, equipment, and material, and the sectors in which the responses occur, to rapid changes in the demand for defense goods. There is insufficient data to understand the relationship of price changes to lead times and capacity utilization for defense goods.

The inadequacy of the data base helps explain the wide range of differing opinions about the ability of the defense industry to quickly and smoothly expand to meet increased demand, and whether the defense buildup will aggravate the bottleneck problem and exert inflationary pressures on the general economy. At the present time, neither the Defense Department or any other agency of the government is able to adequately monitor or forecast the economic effects of the buildup.

In conclusion, we support the general objectives of the defense buildup, which are to strengthen the defense program and enhance our national security. However, these objectives may be unattainable if the buildup causes major industrial bottlenecks or exerts significant inflationary pressures on the general economy. There is substantial evidence to conclude that, as presently planned, the buildup is likely to contribute to bottlenecks and inflation.

To avoid these problems, it would be necessary as a first step to restrain the growth of the defense budget. No magical significance should be attached to any particular rate of defense spending increase. The important thing is to carefully plan for strengthening defense without causing cost overruns or weakening the economy. The fact that the Defense Department was unable to develop a new five-year plan during 1981 based on the revised defense program proposed by the Reagan Administration suggests that the planning process for the buildup is still incomplete. We believe greater attention needs to be paid to the effects of the buildup on both the defense and civilian industries and on the general economy.

E. SOCIAL SPENDING CUTS AND THE "SOCIAL SAFETY NET"

The Administration promised in 1981 to propose spending reductions which preserved the essential protections extended by law to the poor, the elderly, and the disabled. The Administration stated that a "social safety net" would be maintained to protect the "truly needy" from the hardships that severe cost-cutting in government might otherwise impose.

According to the 1980 Census, there are now 29.3 million poor persons in the United States, or about 13 percent of the civilian population. There are 6.2 million poor families; 4.8 million of them have children. There are 3.9 million elderly poor. According to the Social Security Administration, there were in 1981 2.8 million disabled persons, not including the elderly or children.

Contrary to the promises made by the Administration, these populations were not protected from sharp reductions in social programs proposed by the Administration and enacted by Congress in 1981. The social safety net turned out to be a smokescreen, not a net, which served only to obscure the effects of the Administration's budget priorities.

The President, in his message to Congress on February 18, 1981, proposed across-the-board spending cuts, which would have produced savings of $14 billion in Fiscal year 1981 and more than $45 billion in Fiscal Year 1982. In August, the President signed into law the Omnibus Reconciliation Act of 1981 in which Congress provided for $35.2 billion in savings for Fiscal Year 1982, and for major changes in some entitlement programs. Then, in September, the President requested $13 billion in additional spending cuts, of which a substantial proportion were approved by Congress. Thus, the President received a very large fraction of the spending reductions he originally requested.

In the program for Economic Recovery which was presented to Congress on February 18, 1981, the Administration made its commitment to preserve the "social safety net" in these terms:

> The Administration's insistence on this fundamental principle has meant that programs benefiting millions of truly needy beneficiaries have not been affected by the spending control efforts. These programs include social insurance benefits for the elderly, basic unemployment benefits, cash benefits for the chronically poor, and society's obligation to veterans.

The Administration characterized the "truly needy" as those who benefit from seven basic programs. The original seven programs included social security and Supplemental Security Income (SSI), Medicare, Veterans' Disability Compensation and Pensions, free school lunches, Headstart, and summer youth jobs.

The Administration thus defined the "social safety net" very narrowly, as a particular set of programs, and by implication it defined the "truly needy" as the recipients of those programs. The impression was then given to the public that broad categories of people—the elderly poor, the physically disabled, mothers with dependent children—would be protected from hardship. This impression proved to be very misleading.

Poor Families With Children

One of the major "truly needy" groups in our Nation is poor families with children; a family of four is considered poor whose income is $8,414. According to the Bureau of the Census, 77 percent of all poor persons in the United States represent families with one child or more. It estimates that about 50 percent of the families living in poverty are female-headed households. Of these, one-third are poor, as compared to 6.2 percent of married-couple families, and to 11.0 percent of families headed by males with no female present.

There are several major programs that assist poor families with children: Aid to Families with Dependent Children (AFDC); Food Stamps; Medicaid; the school lunch program; summer youth jobs program; Women, Infants, and Children feeding program; Headstart; public and subidized housing; and Title XX of the Social Security Act. Most of the major programs provide noncash benefits to poor families with children except the AFDC program. The summer youth jobs program provides cash benefits for work performed by youth from poor families.

Although the Aid to Families with Dependent Children was not a "social safety net" program, it provides cash benefits to poor families with children. The Administration proposed to cut the AFDC program by approximately $1 billion. The reduction would have reduced benefits for 2 million or one-sixth of the program's beneficiaries. Some of the original proposals submitted by the Administration were modified by the Reconciliation Act, although most of the spending reductions were contained in the bill President Reagan signed into law. The changes are designed to eliminate or reduce benefits for persons with earnings. In so doing, the Administration will reduce work incentives which have been provided through gradual reductions in benefits when recipients get regular jobs, and allow States the option to require employable AFDC beneficiaries to work off their benefits.

Prior to enactment of the Reconciliation Act, families with a stepparent in the home or students older than 18 received AFDC benefits. However, the Act capped the child care expense at $160 per month per child; limited work expense deductions of $160 a month; withdrew the deductibility of the first $30 of earnings plus one-third of additional earnings upon completion of four months of work; included a portion of the stepparent's income for eligibility purposes; and limited the AFDC program to children under 18 only if they attend school. The Department of Health and Human Services estimates that in 1982 approximately 400,000 families will lose benefits, while 259,000 families' benefits will be reduced.

Eligibility for AFDC is limited to families with gross incomes less than 150 percent of State-established need.

Poor families with children are dependent on noncash benefits under the Food Stamp program. The 1980 Bureau of the Census data indicate that about 5.9 million (7 percent) of the 79.1 million households received Food Stamps during 1979; these households receiving Food Stamps included 17.3 million persons:

3.6 million (60 percent) Food Stamp households had total money incomes below the poverty level in 1979; 4.3 million (73 percent) had total money incomes below 125 percent of the poverty level.

3.7 million (63 percent) Food Stamp households were white, 2.1 million (35 percent) were Black, and 0.6 million (10 percent) were of Spanish origin.

2.5 million (42 percent) Food Stamp households consisted of families with a female-headed household, no husband present; 1.7 million (69 percent) of these households were poor.

1.0 million (17 percent) Food Stamp households were 65 years old or over.

3.9 million (66 percent) Food Stamp households had children under 19 years old.

4.5 million (77 percent) Food Stamp households had total money incomes less than $10,000 in 1979.

The Administration's Food Stamp proposals that were enacted by Congress will reduce monthly Food Stamp benefits to households with children in schools offering free lunches. The proposal is based on the assumption that the school lunches could be included in the average daily nutritional requirements, which were otherwise met by Food Stamp benefits. As proposed, the change in benefits would have saved nearly $0.5 billion in Fiscal Year 1982. This figure represents a benefit reduction per month per child of between $11 and $12. Since more than one-third of the families with children receiving Food Stamps have children in schools offering free lunches, approximately six million children from three million households will be affected by the new benefit scheme.

The other major change in the Food Stamp program which the Administration proposed and Congress enacted was to establish a higher floor for income eligibility. The new test would eliminate eligibility for Food Stamps for families with gross monthly incomes at or below 130 percent of the annually indexed "poverty levels," except for households in which a member receives social security, disability, or SSI. The change in the means test was estimated by the Administration to produce savings of $275 million in Fiscal Year 1982. Between 300,000 and 400,000 households or approximately one million persons of the 22 million recipients will not continue to receive benefits. CBO estimates that 1982 savings will be $130 million. Under current law, persons with gross incomes in excess of $11,000 annually will not be eligible for Food Stamps. This proposal will affect less than 5 percent of the 23 million beneficiaries of the Food Stamp program. The total savings for the Food Stamp program in Fiscal Year 1982 are estimated to be $1.5 billion.

According to Bureau of the Census data, more than 8 million households and 18 million persons receive benefits under the Medicaid program. The Medicaid program provides basic medical assistance to 3.8 million households and 9.9 million persons living below the poverty level. Medicaid served 40 percent of all poor households and 55 percent of all poor children under 19 years of age.

The Medicaid program was not included among the original "social safety net" programs, but it is a major health program that serves poor families with dependent children. The Administration's proposal for the Medicaid program, a major entitlement program, was to limit or cap the Federal fiscal liability in Fiscal Year 1982, for savings of $1 billion. This would have represented a limit of a 5 percent increase in the Federal contribution during 1982. The President's fiscal year budget recommendation for Medicaid called for $17.2 billion in outlays for Medicaid or 23.4 percent of the $73.4 billion that was included in the major health category of the budget.

The Administration's plan was not adopted by Congress. Pursuant to the Reconciliation Act, there is a provision for a reduction in Federal matching payments to all States by 3 percent in 1982, 4 percent in 1983, and by 4.5 percent in 1984 rather than the 5 percent originally sought by the Administration. The other provisions allow the States to lower the reductions: if a State adopts a qualified hospital cost review program; if unemployment in the State is greater than 150 percent of the national average; and if a State holds down cost and controls fraud and abuse. The changes will also affect the elderly poor and disabled.

Similar to the reduced funding levels and changes in the eligibility criteria to the AFDC, Food Stamp, and Medicaid programs, the Congress adopted provisions contained in the Reconciliation Act that will affect other programs that contribute to the welfare of the children of families living below the poverty level. Three of the original "social safety net" programs—the Headstart, summer youth jobs, and school lunch programs—benefit poor children across the country. All of these programs are thought to improve future opportunities substantially for the beneficiaries.

The Headstart program, which is one of the original "social safety net" programs, will provide benefits for 375,000 children in Fiscal Year 1982, which is close to the number of children (378,506) served by the program in Fiscal Year 1981. This represents an increase of $130 million above the 1981 funding level, but even so, this level of funding will not allow for the expansion of services to the approximately 80 percent of the eligible children who are not presently able to receive any Headstart benefits. Thus, this part of the "social safety net" protects a relatively small portion of the Nation's eligible children.

The school lunch program, which is one of the smallest of the original "social safety net" programs, is the largest child nutrition program. Almost 100 percent of the $1.4 billion that was cut from the child nutrition programs represents reductions to the school lunch program.

According to the Bureau of the Census, during 1979, the school lunch program served approximately 4.9 million households. The 4.9 million households with children were comprised of the following:

2.1 million (43 percent) households had total money incomes below the poverty level in 1979; 2.7 million (56 percent) had total money incomes below 125 percent of the poverty level.

3.1 million (62 percent) households had a white householder, 1.8 million (36 percent) had a Black householder, and 0.7 million had a householder of Spanish origin.

2.3 million (47 percent) households consisted of families with a female householder, no husband present.

3.4 million (71 percent) civilian householders worked in 1979; 2.5 million (72 percent) of these householders worked 40 weeks or more.

2.2 million (44 percent) householders resided in the South.

The Reconciliation Act reduced funding for the school lunch program through lower Federal subsidies to States and changes in eligibility criteria for participation in both the free and reduced price lunches. Those changes are not expected to affect poor children but, rather, will narrow the universe of eligible recipients. However, the reduced level of Federal support for the school lunch program could have influence on the decision of States to operate school lunch programs in the future.

The Department of Agriculture indicates that at least 1,500 of 94,000 participating schools will no longer participate in the school lunch program. Of this number, approximately 500 are public schools, 200 are residential care institutions which provide 24-hour care to orphanages, and 800 are private schools. 2.8 million children will not receive lunches. Of this amount, approximately

650,000 children would have received free meals, 250,000 children would have received a reduced price meal, and about 1.90 million would have received a paid meal prior to the changes in eligibility.

The children of poor families will not lose benefits in general because of the reduced level of Federal support and changes in income eligibility. The long-term implication of these factors, however, will be an increase in the demand for nonfederal funds in the form of higher meal costs and/or a decrease in the demand for the service among children and schools. According to the results of the Congressional Research Service's report, "Description and Effect of Reconciliation Legislation on the School Lunch Program," the extent of the effect of the changes in eligibility and reduced Federal subsidies will vary significantly among school districts depending upon their operating costs, their proportion of children receiving paid, free, or reduced price lunches, and their ability to make up for lost revenue either through the production of less expensive lunches, or greater local funding sources or some combination of both (see Table I-9). The income eligibility changes will result in savings of approximately $360 million for Fiscal Year 1982. Other savings will occur as a result of cutoff levels. The USDA estimates that a total of approximately 1.6 million fewer children will be participating in the free and reduced price lunch program because of changes in the Omnibus Reconciliation Act of 1981.

TABLE I-9.—SCHOOL LUNCH PROGRAMS ESTIMATE FOR 1981-82 SCHOOL YEAR

	1980-81 actual	Old law	New law	Old/new law difference
Federal reimbursement (cents):				
Paid lunch	29.50	37.00	21.50	−15.50
Free lunch	113.00	128.50	120.25	−8.25
Reduced-price lunch	93.00	108.50	80.25	−28.25
Income eligibility criteria as percent of poverty level:				
Reduced-price meals	(1)	(1)	(2)	(2)
Free meals	(3)	(3)	(4)	(4)
As level of income for family of 4:				
Reduced-price meals	15,490	17,740	15,630	−2,110
Free meals	10,270	11,380	10,990	−390

[1] 195 percent plus standard deduction of $960 per year.
[2] 185 percent with no standard deduction.
[3] 125 percent plus standard deduction of $960 per year.
[4] 130 percent with no standard deduction.

Source: Congressional Research Service Report, "Description and Effect of Reconciliation Legislation on the School Lunch Program," by Jean Y. Jones, January 13, 1982.

Unemployment among teenagers, particularly from socially and economically disadvantaged households, has reached epidemic proportions during the 1980's. This is a pattern which is expected to continue over the long term. The unemployment problem of teenagers is, in part, a seasonal problem. The Congress enacted the summer youth jobs program to address seasonal unemployment among youth and assist youth in early skill development. However, the Administration made funding recommendations for the program which will make it ineffective to serve unemployed teenagers during the summer of 1982.

The Administration included the summer youth jobs program as part of the "social safety net." The summer youth jobs program was funded at $839 million in 1981. The Administration proposed a $766 million funding level for Fiscal Year 1982. The Continuing Resolution provides a $640 million funding level for the summer youth jobs program, which is lower than the President's recommendation.

The program served approximately one million socially and economically disadvantaged teenagers in 1981. The 1982 funding level of $640 million will provide summer employment opportunities for between 700,000 and 800,000 teenagers. This represents a 20 to 30 percent reduction in the number of youth who will receive jobs during the summer of 1982 as compared to 1981. Since the unemployment rate among minority youth will probably exceed 40 percent during the summer of 1982, the level of funding will be inadequate to meet the need. Moreover, this could be the last year for the program since the Administration has recommended that the program be eliminated.

The Disabled and Elderly Poor

The Social Security Administration estimates that, for the year ending 1981, there were 2,777,000 disabled persons in the United States. This does not include disabled children or elderly disabled persons. There were over 3,871,000 elderly poor persons as of 1980 in the United States or 15.2 percent of all persons living below the poverty line. Two-thirds of the income security function of the Federal budget provides benefits to persons who are disabled or retired. The Administration's budget recommendations to Congress proposed reducing outlays by $5.3 billion in Fiscal Year 1982 for these programs. The "social safety net" was supposed to have protected the disabled and elderly poor, but a disproportionate amount of the reductions to retirement and disability programs occurred in the Old Age, Survivors and Disability Insurance (OASDI) program.

There were four fundamental changes to the OASDI program. These changes represent a $1.7 billion reduction in Fiscal Year 1982, less than 50 percent of the total reducions for retirement and disability programs. These reductions include the following:

(1) Elimination of the social security minimum benefit ($0.2 billion); and

(2) Partial elimination of social security death benefits ($0.2 billion).

The Social Security Disability Insurance program is the basic means of income replacement for workers who are unable to work due to a disabling condition. Of the 4.6 million beneficiaries of the DI program, more than half are disabled workers (2.8 million). The average monthly payment to single disabled workers was $396 compared to $809 for disabled workers with dependents in 1980.

The Reconciliation Act of 1981 included provisions to establish a "mega cap" and eliminate funding for vocational rehabilitation services. DI benefits are offset because of workers' compensation and other benefits such as black lung benefits. Prior to the 1981 Reconciliation Act, the offset provided for a reduction in the monthly benefits for a disabled worker under age 62 (and his family) when the combined workers' compensation and DI benefit payments exceed 80 percent of the average current earnings prior to the disability. The amount of the reduction is the amount by which the combined payment exceed the higher of 80 percent of the average current earnings, or the family's total social security benefits.

Under Reconciliation, the "mega gap"is intended to limit public disability benefits so that they do not exceed a worker's pre-disability after-tax earned income which is approximately 80 percent of earnings adjusted for inflation. The workers aggregated Federal, State, and local benefit payments cannot exceed the higher of 80 percent of the worker's disability earnings or the disabled worker family's total social security benefits. The offest or "mega cap" provision also applies to beneficiaries aged 62 through 64, rather than the previous cutoff of 62.

Another major provision of the Reconciliation Act eliminates the use of trust fund money to fund rehabilitation services. State agencies will be reimbursed only where rehabilitation services produce gainful employment for the worker for a continuous nine-month period. The trust funds had provided higher benefits per person and ensured that severly disabled persons would receive assistance. However, the block grant approach to funding will lessen the chance of a DI beneficiary receiving vocational rehabilitation since States can design their rehabilitation programs to ensure that they result in work for the disabled.

The one group in America that is most characteristic of the "truly needy" is the elderly poor. As mentioned earlier, the elderly poor are classifed by the Bureau of the Census as persons 65 or older whose incomes are less than $4,190. The elderly poor number less than 5 percent of all poor persons in the United States, of which most receive some form of food, health, income security, and disability benefits.

The "social safety net" as defined by the Administration included four basic programs that serve the elderly poor: Medicare, social security, Veterans' Pensions, and Supplementary Security Income. All of these programs except the veteran's program were affected by the passage of the Omnibus Reconciliation Act.

Medicare is a major "social safety net" program for which the Administration proposed reductions in funding. The Medicare program serves both the aged and the disabled. The program is designed to provide basic protection against the costs of hospital and related post-hospital services. Fifteen million or 81 percent of the households with persons 65 years old and over are covered by Medicare. Approximately 3 million or 20 percent of these persons' incomes are below the poverty level. Medicare benefits under the Reagan budget proposal totaled $47.1 billion or more than 50 percent of the outlays proposed in the health portion of the Federal budget.

The Congress adopted several reforms to the Medicare program that are expected to reduce program costs by $4.4 billion over the next five years. Beneficiaries will experience $3.9 billion of these cuts. The reforms to the Medicare program adopted by Congress include several major changes. One provision eliminates occupational therapy as a basis for entitlement to home health services. The second provision relates to changes in Medicare coinsurance. This change allows for a $28 increase in the hospital deductible per ad-mission in 1982, and a $5 increase in the annual deductible for physician services. The Congress also adopted changes in provider reimbursement by reducing to 5 percent the current 8.5 percent bonus paid to hospitals for nursing services to Medicare patients and reducing the limit on maximum reimbursement to hospitals, from 112 percent to 108 percent of the average cost for similar hospitals.

The provisions are estimated to result in $1.5 billion in savings in Fiscal Year 1982, $1.2 billion in Fiscal Year 1983, and $1.3 billion in Fiscal Year 1984. The savings will affect elderly presons served by the program, more than 14 percent of whom have incomes below the poverty level.

Although the Medicaid program was not part of the original "social safety net," the program was established in part to provide Federal aid to States for medical assistance to low-income elderly and disabled persons. The States design their own Medicaid programs. The level of benefits and eligibility criteria differ from State to State because of the flexibility in the program. The Federal Government matches the State's share for the Medicaid program by inversely relating its share to a State's per capital income. The matching rate is between 50 and 83 percent of the cost of the program.

Of the 15.8 million persons who receive benefits under the Medicaid program, 5.4 million are elderly persons. Most of the cost escalation in the program is a result of the steady increase in elderly beneficiaries who need long-term care. Although the elderly constitutes 15 percent of the Medicaid beneficiaries, 30 percent of the cost of the program is attributed to the elderly poor.

The social security benefits for the elderly will exceed $159 billion in Fiscal Year 1982. The cuts in social security benefits will total $17.9 billion over the next five years. There are several basic structural changes enacted by Congress to the social security system which were proposed by the Reagan Administration. However, the elimination of the $122 minimum benefit for future retirees and the lump-sum death benefit for those beneficiaries who die and fail to leave an eligible surviving spouse or entitled child will affect the elderly. More than 100,000 persons will not be eligible for minimum benefits in 1982.

Under law, a beneficiary whose average lifetime earnings in covered employment was low received a minimum higher benefit than the benefit they would otherwise receive. The minimum benefit provision was designed to assist the poor and persons with other sources of retirement income. The Administration's proposal to eliminate the minimum benefit for those persons 65 or older who could meet income eligibility criteria assumes that the benefits would be replaced by social security income payments. The Congress approved a provision in the Reconciliation Act that will allow for the replacement of the minimum benefit with SSI payments for persons who turned 62 after December 31, 1981. Retirees who lose the minimum benefit will receive social security benefits based on actual earned wages. The new benefits will not exceed $122 a month.

The elimination of the lump-sum death benefit where there is no widow or a dependent child as proposed by the Administration was estimated to save $200 million. The law provides a $225 lump-sum payment for social security beneficiaries. However, the Reconciliation legislation restricts payment of the benefits.

The Food Stamp program serves 2.5 million elderly poor persons, or little more than 10 percent of the program's beneficiaries. Three of the Reagan proposals to reduce Food Stamp expenditures would have substantially affected the elderly:

(1) To establish the 130 percent gross income eligibility limit;

(2) To freeze the $85 per month standard deduction permanently; and

(3) Repeal of the provision scheduled to take effect in fiscal year 1982, that would have increased benefits to elderly recipients with medical expenses by allowing these recipients to have an additional $10 per month in medical expenses disregarded when benefits are calculated.

The Omnibus Reconciliation Act contains $600 million in savings that will affect the elderly. Although the Congress exempted households with persons aged 60 or over or disabled members from the lower eligibility limits and froze the $85 per month "standard deduction," the Act provides for delayed adjustment of benefit levels, rather than the annual adjustment which will have a significant impact on the elderly poor. The Reconciliation Act also includes the Reagan proposal to repeal increased benefits to elderly recipients with medical expenses.

The Administration also proposed consolidation of 12 social services program into a block grant for States. Pursuant to the Reconciliation Act, Congress did create a block grant for social services provided to the elderly poor. Approximately 20 to 25 percent of the Title XX funding provides benefits for the elderly poor. The funding level is $2.4 billion for fiscal year 1982. The States are given greater flexibility in designing their own programs for the elderly poor.

Other major programs that serve the elderly poor, including nutrition, employment, housing, education, transportation, weatherization, legal services, senior volunteer programs, the community services block grant, and the social services programs were affected by provisions in the Omnibus Reconciliation Act of 1981.

Both Veterans' Disability Compensation and Veterans' Pensions programs were not affected by the Reconciliation Act. The two programs which were considered by the Administration to be part of the "social safety net" are funded at $13.5 billion in fiscal year 1982. The compensation payments will provide assistance to 2.6 million veterans and their survivors as a result of disabilities related to military service.

The Veterans' Pensions program serves approximately 2 million veterans who are poor and are either disabled or at least 65 years old. Veterans are the only group originally defined as needing a cushion against poverty who was not affected directly by the actions of the Administration and the Congress, since the Reconciliation Act of 1981 did not alter program benefits.

Although the seven programs included in the "social safety net" were not substantially reduced by the Congress, the reductions in funding for other entitlement and numerous human services programs will place the poor in a relatively worse position.

Clearly, the "truly needy," the poor families with children, the disabled, and the elderly people, will be worse off. Of the seven "social safety net" programs designated by the Reagan Administration (Old Age, Survivors, and Disability Insurance, Medicare health insurance, Veteran's Pension and Disability Compensation benefits, Supplemental Security Income, Headstart preschool education, summer jobs for economically disadvantaged youths, and free school lunches), only the latter four are limited to the "truly needy." Their funding levels are only a small fraction—one-seventeenth of the total for the first three programs. The first three programs, which make up more than 90 percent of the spending for the seven do form a "safety net." However, it is a "safety net" for the elderly, not for the poor. An estimated 86 percent of these program recipients have incomes above the poverty level. The "social safety net" programs designated by the Administration, therefore, do little to serve the poverty population. Only 14 percent of the Medicare benefits go to persons with incomes below the poverty line.

In contrast to the "safety net" programs, 17 major programs for the "truly needy" are targeted for $25 billion in cuts. The Congressional Budget Office (CBO) has estimated that up to 25 million people, most of them the needy, would lose some benefits because of proposed cuts in just four of these programs: welfare, Food Stamps, public service jobs, and school lunches. Likewise, there are a multitude of programs benefiting the middle class and in some instances, the poor as well, which will be cut in addition to those mentioned above. Cuts in funding for urban mass transit systems, scholarship and student loan programs, art and humanities programs, unemployment insurance, and many health, education, and social service programs that have been combined into block grants will be felt by millions of middle-income Americans.

F. THE EFFECT OF THE REAGAN PROGRAM ON STATE AND LOCAL GOVERNMENT FINANCES

City Government Finances

For several years, the Joint Economic Committee has been conducting surveys of the fiscal condition of cities. With each survey, the results are more grim. Our 1980 survey found that, despite a period of national economic recovery, cities, generally, had not flourished. An increasing proportion experienced operating deficits in 1979, and that trend was projected to continue. The number and proportion of cities which reported operating deficits for 1980 in our 1981 survey, however, surpassed even the most pessimistic projections. At that time, more than 50 percent of the cities reported operating deficits. Although these were not confined to a particular size category, for 1980 over 70 percent of the largest cities were in deficit and all but four of the 29 respondents anticipated running deficits in 1981. The 1981 report predicted that, in order to merely maintain existing service levels, many cities would find it necessary to further increase local taxes, user charges, and fees.

According to the results of our most recent survey, taken in the Fall of 1981, these predictions have been borne out. This was an emergency interim survey of 48 large cities conducted to determine the effect of the Federal tax and spending package on cities and their residents. An emergency survey was deemed necessary because the extent and magnitude of the Federal actions on local government appeared to be severe.

The main finding of the survey was that a majority of the respondents are reducing their real service expenditure levels for virtually every service examined; these include police, fire, sanitation, health, and recreation. In addition, increases in tax rates, user charges and fees, and postponement of capital projects are widespread.

In our 1980 survey, we noted that three factors were responsible for the solvency of a number of cities: national economic recovery, increased direct Federal assistance, and deferred capital expenditures.

These factors have changed and their implications for city solvency are examined below:

National Economy

For the past several years, cities have been buffeted by inflation; now, recession is compounding their fiscal problems. Because cities rely on property taxes, which in the short run are not inflation-sensitive, as their primary source of revenue, increases in expenditures have tended to outpace revenue increases. Thus, inflation has tended to generate deficits for many cities. In response, many cities have increased their reliance on cyclically sensitive income and sales taxes, and user charges. While these sources may generate additional revenue during recovery and inflation, they render cities more vulnerable to economic downturns. The effect of the current recession will, therefore, be magnified by reduced revenues from these sources, in addition to sharp reductions in Federal assistance.

Federal Assistance

In 1982, for the first time, direct Federal assistance to State and local governments has been reduced in nominal terms—from $94.8 billion in 1981 to an estimated $91.2 billion in 1982. This amounts to a reduction of 12.3 percent in real terms, after inflation. And this nominal reduction followed three years in which Federal intergovernmental assistance showed no growth in real terms; increasing by 7.6, 6.6, and 3.6 percent in 1979, 1980, and 1981, respectively; or less than the three-year rate of inflation.

These sharp reductions in Federal aid have a particularly chilling effect on the cities most dependent on this source of revenue. These tend to be the most fiscally strapped cities—those with high unemployment rates and with declining populations. Over all, in 1980, Federal grants-in-aid represented 30.4 percent of State-local receipts from own sources, a reduction from the 1976 peak of 34.4 percent. In some cities, however, the dependence is still considerable. For 1980, Federal aid to Baltimore was 47 percent of own-source revenues; in Detroit, it was 44 percent; and in Buffalo, 60 percent. For these and many other cities, sharp reductions in Federal aid are almost certain to be accompanied by real reductions in service levels, and increased tax rates and user charges and fees. In the past, such actions have led to the outmigration of firms and population. This trend can be expected to continue and intensify.

Capital Deferrals

Capital projects have typically been a prime and early target of State and local budget cuts. Postponement of projects such as bridge repainting, sewer and road improvements, and park and building maintenance tend to be invisible in the short run. Over the long haul, however, they impede the ability of the city to attract business and residents in an effort to increase its tax base, and discourage existing firms and residents from remaining.

Of the three factors, national economic recovery, Federal aid, and capital deferrals, the last is the only one still contributing to fiscal solvency. However, while capital projects have, in the past, provided an open door for reductions to State and local officials caught in a fiscal squeeze, in many cities this door is closing. Capital deferrals can only continue so long before actual replacement of the facility becomes imperative. Local officials aware of the limited lifespan of their facilities are often reluctant to allow projects to reach this stage. Thus, deferrals cannot continue endlessly. Further, local officials are increasingly aware of the importance of an adequate physical plant to the future economic well-being of the city. Thus, while deferrals of capital projects continue, the magnitude of deferrals may decline in the future.

Because in the current economic environment the downturn in the national economy and reduced Federal assistance are placing additional strain on local budgets, cities are finding it necessary to take additional discretionary actions to bring expenditures in line with revenues. The Committee's most recent emergency fiscal survey revealed widespread use of such actions by cities to maintain their solvency. Specifically, these actions are:

> (1) *Reductions in service expenditures.*—A majority of the cities surveyed have budgeted for real expenditure reductions in virtually every service examined; these include police, fire, sanitation, health, and recreation. For each service, over 50 percent of the respondents had actually reduced expenditures or increased them by 9 percent or less—below the rate of inflation. This trend is particularly pronounced for those cities with unemployment rates above 6 percent. A majority of these cities have budgeted for real funding declines for every service; except fire expenditures in cities with unemployment rates between 6 to 10 percent which were increased.
>
> Health expenditures suffered real expenditure declines by the largest number of cities (67 percent). Thirty percent of the respondents have budgeted for expenditure reductions in actual nominal dollars, and over 80 percent of the high unemployment cities (10 percent or more) have budgeted for real reductions in health expenditures.
>
> In comparing growing and declining cities, the survey revealed that a majority of cities in both of these categories have budgeted for real reductions in every service except one—58 percent of the growing cities plan to increase sanitation expenditures in real terms.

(2) *Tax Rate Change.*—Over 40 percent of the respondents increased tax rates. Half of these cities had unemployment rates of 10 percent or more for the first 10 months of 1981. Similarly, four declining cities raised tax rates for each growing city which did so. The majority of rate increases were for property and sales taxes. Thus, the taxes which are being raised are likely to disproportionately burden the poor.

(3) *User Charge and Fee Incrases.*—Over 60 percent of the cities surveyed increased user charges and fees between 1981 and 1982. These are the charges paid for the use of a particular service or facility such as municipal parks, swimming pools, libraries, etc. In addition, fee increases for drivers licenses, building permits, and fines, as well as fees for the use of water and sewer lines (if included in the city's general fund account) are included in this category. Although more high unemployment cities increased the largest number of fees (45 percent of all fees).

(4) *Capital Deferrals.*—Data on capital deferrals were provided by 18 cities, although others indicated that deferrals had occurred but the data were not readily available. Typical of the deferrals were projects for water and sewer treatment plants and improvements, bridge and viaduct repair, street and road work, and building and park maintenance. The largest per city deferrals occurred in the low unemployment respondents which had deferred capital expenditures had postponed more than $150 million in projects, three of the eight growing city respondents did likewise. The majority of the cities with unemployment rates above 6 percent deferred capital expenditures by $25 million or less as did a majority of the declining cities.

These discretionary actions were necessitated in part by sharp and widespread declines in both Federal and State assistance. Ninety-three percent of all respondents expect declines in Federal aid in fiscal year 1982. High unemployment and declining cities are expecting to lose the largest proportions of Federal aid. Twenty-four percent of the high unemployment cities and 27 percent of declining cities expect to lose over 36 percent of their 1981 Federal aid.

Likewise, 88 percent of the 41 cities expect real declines in State aid. Of these, 71 percent anticipate actual reductions or no growth in absolute dollars over the 1981 level.

It does not appear that crises can long be avoided in many high unemployment and declining cities. City service levels and physical plant are continuing to deteriorate and at the same time business and residential costs are increasing. Those that can will continue to heed the President's advice and "vote with their feet." [5] This will not only create a deepening state of distress, but will render these cities home for the most dependent segments of society—the undereducated, the unemployed, the aged, and the minorities. These individuals have neither the means to leave nor the skills to improve their plight if they did. It, therefore, becomes difficult to imagine that the private sector in these cities will be capable of training or employing a significant proportion of the unemployed or in significantly enhancing the local tax base. A city which is in the process of raising taxes and cutting services and which is resting on a decaying infrastructure provides no inducement to business expansion or immigration.

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[5] New York Times, Nov. 22, 1981, p. 1.

The report also revealed problems ahead for many of the growing cities—particularly those that have been growing rapidly and have been unable to improve and expand their capital facilities in accordance with their increased population needs. Continued deferrals of projects intended to improve these deficiencies, coupled with widespread increases in user charges and fees, may result in a deterioration in the advantages presently enjoyed by these cities in attracting population and businesses.

The outlook for cities based on these data is bleak, and it is anticipated that city budgets will be further crippled by additional cuts in aid to the State and local sector which the President has proposed in the Fiscal Year 1983 Budget.

State Government Finances

Not only cities, but States, too, are showing signs of fiscal stress. A recent survey conducted by the National Governor's Association (NGA) indicates that for fiscal year 1981 State governments expected to increase their expenditures by 14 percent and their revenues by 8 percent—a difference of approximately $7 billion. To accomplish this, States will have to draw down their carryover balances. As a result, the report estimates that fiscal year 1981 balances will be 3.3 percent of expenditures and, in fiscal year 1982, 1.5 percent. It is generally considered sound fiscal management to maintain balances at 5 to 6 percent of current expenditures. For most non-energy producing States, fiscal conditions were worse in fiscal year 1981 than 1980 and are expected to grow still worse in fiscal year 1982.

According to a January 1982 survey by the National Conference of State Legislatures (NCSL), 29 States expect their 1982 year-end balances to equal 1 percent or less of their annual spending. Twelve States anticipate running deficits and another 10 anticipate balances between 1 to 5 percent of their spending. Of the States which anticipate running surpluses, seven expect their balances to exceed 10 percent; these are Kansas, Nevada, New Mexico, North Dakota, Oklahoma, Texas, and Wyoming.

The outlook for State governments, like that of their city government progeny, is not rosy. Twenty-four States anticipate revenues and 19 anticipate expenditures will increase by 8 percent or less in 1982. The NCSL report concludes that "many (1982) budgets can be characterized as austere." [6] These estimates, made prior to the enactment of the 1982 Federal Budget, and before the severity of the national recession became clear, are likely to be overly optimistic. In all probability, Federal assistance was overestimated and the effect of the Federal tax cut on State finances, underestimated. Approximately 30 States tie their corporate tax rates to Federal tax rates and, as the latter is reduced, State tax rates automatically decline.

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[6] Gold, Steven D. and Karen M. Benker. "State Fiscal Conditions as States Entered 1982." National Conference of State Legislatures, Denver, Colo. January 1982, p. 3.

The NGA estimates that the Federal tax legislation will cost States about $2 billion in lost corporate tax revenues in FY 1982. In addition, elastic revenue sources such as sales and income taxes are buoyed during inflationary periods. Not only do revenues from these sources generally decline during recessions, but State budgets are further strained by additional outlays for social services necessitated by economic slow downs. Further, the Municipal Finance Officers Association (MFOA) estimates that States and cities will pay up to an extra $1.1 billion in finance costs this year due to competition from the All-Savers tax-exempt certificates.

The strain on State budgets will undoubtedly be felt by the Nation's cities and their residents as State as well as Federal intergovernmental assistance is reduced. Moreover, very likely it will dramatically affect the course of Federalism in the near term and in years to come.

Part II. RECOMMENDATIONS AND ANALYSIS

A. End the Recession

Recommendation No. 1: End the Recession

> **We reject the idea that unemployment is necessary to fight inflation. The Administration's economic strategy is causing vast and unnecessary hardship, with a virtual guarantee that huge future deficits will overwhelm any temporary abatement of inflation once economic recovery is permitted to begin. We believe that durable price stability and a balanced budget can be achieved only in the context of economic growth; therefore, an early end to the recession is imperative.**

More men, more women, and more young people are unemployed today in the United States, in absolute numbers, than at any time since 1939. In the last five months of 1981, the number of unemployed persons increased by 1.7 million. Most of these are prime age adults, the principal breadwinners for their families and the mainstays of America's industrial labor force. Worse, a smaller proportion are covered by unemployment insurance than in any post-war recession, due to budget cuts and the shortness of the recovery from the previous, 1980 recession.

This recession is unique in another aspect. For the first time since 1932, the Administration in power in Washington has abandoned even the pretext of empathy for the unemployed. As far as this Administration is concerned, the Employment Act of 1946 is a dead letter, and so is the more recent and extensive Full Employment and Balanced Growth Act of 1978. Administration policy caused this recession and now threatens to prolong it. And yet, when confronted with the resulting unemployment, the White House shrugs. "Unemployment is just the price we have to pay to fight inflation," said Presidential spokesman Larry Speakes the day that November's jobless rate (8.3 percent) was announced.

To us, today's unemployment is an unmitigated evil. It is pointless, it is unnecessary, and it will not effectively fight inflation. Policies to end the recession, to restore economic growth, to rehire the jobless, and to fight inflation effectively and lastingly are a legal and a moral imperative.

The folly of relying on recessions to control inflation is demonstrated by Table II-1. During each recession in the post-war period, inflation has indeed retreated from its pre-recession peak, as the table shows. But during the recovery and growth period which follows, inflation regained its old momentum and often moved even higher. During our last prolonged recession under President Ford, for example, inflation fell from 12.2 percent in 1974 to 4.8 percent in 1976, as measured by December-to-December changes in the Consumer Price Index. But it then rebounded to 13.3 percent by 1979. The same pattern can be seen surrounding other recessions.

TABLE II-1.—INFLATION RATES

Recession	Previous peak	Recession low	1 year later	2 years later
1969-70	6.1(1969)	3.4(1971)	3.4	8.8
1973-75	12.2(1974)	4.8(1976)	6.8	9.0
1980	13.3(1979)	8.9(1981)		

Source: Bureau of Labor Statistics, Changes in Consumer Price Index, Measured on December-to-December Basis, Listed Year over Previous Year.

While the benefits are thus transitory, the human and economic costs of recession and prolonged high unemployment need not and should not be accepted. Not only does unemployment seriously threaten the welfare of millions of American families, and leave in want hundreds of thousands who will exhaust their unemployment benefits in 1982; it will also impair our ability to fight inflation in the long run as productive capacity stands unused, national investment needs in both the public and private sectors go unmet, and prolonged idleness erodes workers' skills.

The Unemployment Crisis

Between July and December of 1981, the number of unemployed persons rose to 9.5 million, the highest level since the 1930's. Although the overall unemployment rate dropped slightly to 8.5 percent in January of 1982, probably due to bad weather, it approaches the worst point of the 1974 to 1975 recession, and threatens to keep climbing. On January 19, 1982, Nobel Prize-winning economist James Tobin testified to the Committee that, in the absence of an adjustment in policy, "there is a good chance we have already seen the lowest unemployment rate of the first half decade of the 1980's or this Presidential term."

Compared with previous downturns, unemployment was much higher at the start of the 1981 recession. The short, weak recovery from the 1980 recession had left the country with a jobless rate of 7.2 percent, well above any reasonable definition of full employment. This reflected a long-standing pattern of the business cycle: ever since the 1960's, the recovery phases of the business cycle have failed to reduce unemployment to pre-recession levels. Each time, moreover, these "recovery" rates of unemployment have moved upward, as shown in Table II-2.

TABLE II-2.—UMEMPLOYMENT RATES

[In percent]

Recession	Previous low	Recession high	Recovery low
1969-70	3.5	5.9	4.6 (Oct. 1973).
1973-75	4.8	8.6	5.7 (May 1979).
1980	6.3	7.8	7.2 (July 1981).

Source: Bureau of Labor Statistics, Peaks and troughs of each cycle correspond to the determinations of the National Bureau of Economic Research.

In each of the recessions since the late 1960's, cyclically sensitive sectors like construction and durable goods manufacturing, and also those industrial regions which had suffered the most unemployment, had only partly rebounded by the time the next slowdown occurred.

Layoffs have been responsible for most of the additional unemployment experienced in the last half of 1981. Workers entering or reentering the labor force accounted for only about one-fourth of the increased unemployment over this period. Labor force growth was generally slow in 1981, partly because of discouraging job market conditions, partly because of demographic factors. There are no longer record numbers of women and youth seeking work, as was the case in the 1974–75 recession.

Between July and December, the number of unemployed workers who lost their last job has risen by 1.5 million. While the job losses have become increasingly widespread, construction and durable goods industries have borne the brunt of the 1981 recession to date.

For example, nearly one in five construction workers was jobless by the end of 1981; unemployment in that sector jumped by 137,000. In manufacturing, unemployment increased by 842,000; 80 percent of that increase was in durable goods production. New layoffs hit the transportation sector, where approximately 200,000 auto workers were already on indefinite layoff; from July through December, and additional 118,000 transportation workers were out of a job. Other industries experiencing sharp declines in employment included primary and fabricated metals, electrical equipment, machinery, lumber, and other industries that furnish inputs to homebuilding and auto production, such as fabric, concrete, and plaster products.

By the end of the year, however, the recession had spread to other sectors of the economy, including industries that are generally more resistent to cyclical fluctuations. Employment in service industries declined by about 100,000 jobs between October and December, and over 200,000 workers in such occupations have been added to the unemployment rolls since the summer. Employment in nondurable goods industries also dropped sharply, leaving 170,000 additional workers jobless. Only 30 percent of all industries surveyed in December were reporting any employment growth. And the holiday-related burst of retail hiring normally seen in December did not happen.

Adult men experienced the sharpest increases in unemployment during 1981, because they tend to hold jobs in cyclically sensitive industries. Between July and December, the jobless rate for adult men jumped from 5.8 percent to 7.9 percent, and currently exceeds the rate for adult women. Close to 40 percent of the unemployed were heads of households, a higher proportion than usual. Minority unemployment has risen more than 2 percentage points, to a record of 15.7 percent, since December of 1980. And among minority teenagers, unemployment has been hovering around 40 percent, after shooting above 45 percent during the summer. Thus this recession has brought the unemployment rates of several population groups above their previous post-World War II high points and, in all cases, above the highest levels reached in 1980, as shown below.

TABLE II-3.—UNEMPLOYMENT RATES

[In percent]

	December 1981	High point 1980	High point 1975
All workers	8.8	7.8	9.0
Adult men	7.9	6.7	7.3
Adult women	7.4	6.7	8.5
Teenagers	21.5	19.1	20.9
Whites	7.7	6.9	8.4
Minorities	15.7	14.0	14.4

Geographically, the industrial Northcentral and Midwestern States, which accounted for most of the rising unemployment in 1980, still have the most serious joblessness, together with the States in the Pacific Northwest, which are hard hit by the long slump in homebuilding. The unemployment rate in Michigan is 14.9 percent. Other States with unemployment rates above 10 percent are Ohio, Indiana, Alabama, Oregon, and Washington.

The increases in unemployment during 1981 were somewhat less regionally concentrated than during 1980, however, since the current recession spread well beyond the auto and construction sectors. The five States with the largest increases in unemployment were California, Ohio, Florida, Tennessee, and Pennsylvania. In addition, several States experienced disportionately large increases given the sizes of their labor forces: in Alabama, Tennessee, Oregon, Maryland, South Carolina, and Kentucky, the State unemployment rate rose more than 2 percentage points in 1981.

Recommendation No. 2: Immediate Relief for the Unemployed

> **Unemployment insurance coverage is inadequate in this recession and must be extended to assure a maximum of 39 weeks of benefits in all 50 States. The effective date of the new provisions regarding Federal loans to State unemployment insurance programs should be delayed by one year, to minimize the need for States to institute cutbacks in benefits in the midst of recession. Congress should also repeal the changes in the Extended Benefits program that require higher State trigger levels and a new method of calculating trigger unemployment rates.**
>
> **Eligibility for the Targeted Jobs Tax Credit should be extended to workers unemployed longer than 15 weeks and to workers whose earnings from previous employment were less than $6,500 a year.**

Beginning with the establishment of unemployment insurance nearly 50 years ago, government programs have provided a safety net to protect the jobless during a recession. While, in the past, such measures were typically increased during recessions, the budget cuts pushed through Congress by the Reagan Administration in the past year have left much of the safety net in shreds.

The public service jobs program, which provided, 700,000 jobs at its peak, was completely dismantled. Unemployment insurance rules were tightened and new restrictions were placed on the Trade Adjustment Assistance program. Other income support programs were slashed, including $1 billion from Medicaid and $1.7 billion from Food Stamps. Changes in the AFDC program sharply reduced benefits to households with some earnings, making it more difficult for those on the fringes of the labor market to escape dependence on welfare.

The reduced protection available through the unemployment insurance system—partly coincidental and partly the result of budget cuts—will make the 1981 to 1982 recession an unusually painful one for millions of families. Currently, only about 4 million persons—about 40 percent of the unemployed—are drawing unemployment insurance benefits. This proportion is significantly lower than in previous recessions. In 1980, for example, an average of 50 percent of the unemployed received benefits.

One reason may be the back-to-back nature of the 1980 and 1981 recessions. Many persons who collected unemployment insurance in 1980 were not reemployed long enough during the short 1980 to 1981 recovery to reestablish their eligibility before the next round of layoffs occurred. In addition, a somewhat higher proportion of the unemployed have already exhausted their benefits. While typically about one-fourth of unemployment insurance recipients at any time are drawing their final payments, the exhaustion rate in October of 1981 was up to 31 percent.

Legislated changes in various aspects of unemployment insurance have also reduced participation in the program. Most States during 1981 instituted stricter eligibility rules for the regular, 26-week program, raising either the minimum number of weeks of work or the dollar amount of earnings needed to qualify for a particular level of benefits. Some of these moves may have been in response to Federal law changes which limit the ability of States to borrow from the Federal Government when their revenues for unemployment insurance benefits run short. Under the 1981 Budget Act, State programs which fail to meet certain tests of solvency will face new penalties, including the payment of interest on Federal loans.

States with high levels of unemployment are most likely to have outstanding loans for these programs, or to face the need for new borrowing in fiscal 1982. Thus, the provisions will probably require the most significant cost-cutting steps in States where the burden of the recession is the greatest.

The fiscal 1981 budget resolution also scaled back the extended benefits program, which offers up to 13 weeks of additional benefits when unemployment is exceptionally high. While some of the changes—such as higher State trigger levels—have yet to take effect, extended benefits are currently available in only 13 States and Puerto Rico. One such change actually eliminated the program in Michigan, despite the obvious severity of unemployment there. By requiring that persons collecting extended benefits be excluded from the computation of the trigger unemployment rate, this new provision may soon cause similar cut-offs of the program in a number of other vulnerable States.

The goal of the unemployment insurance system should be short-term help; it is not a substitute for measures to bring the recession to an end and encourage the reemployment of idled workers. A prolonged recession and protracted recovery, in which the unemployment rate remains high for a year or more, could saddle the Nation with increasingly costly structural employment problems. Many of those who are unemployed for long periods of time will lose their job skills or find themselves increasingly mismatched as factories and businesses which had formerly employed them disappear. Beyond the hardship for individuals and their families, increasing the numbers with chronic employment problems will add to the pressures on support programs whose growth the government is currently trying to restrain.

There are several ways in which cyclical unemployment can become a more serious and lasting problem. In addition to the problem of skill obsolescence, the psychological effects of idleness and dependence are demoralizing and can impair attitudes toward work, future job performance, and even a worker's ability to hold a regular job.

Further, many young workers entering the labor force for the first time will not obtain needed work skills and experience. Often, the first three or four years of full-time employment are used to experiment with different kinds of jobs and to become accustomed to the demands of full-time work. If unemployment remains high for a prolonged period of time, many young people may reach maturity without ever holding a full-time job.

Although most firms can endure short periods of underutilization without damaging their ability to recover, a longer period of poor business may prove fatal to firms in tenuous financial condition, particularly in light of today's high interest rates. If such firms employ specialized skilled workers or are located in cities or towns with few alternative employers, workers may then need retraining, placement, and relocation assistance to regain productive jobs.

Properly designed incentives for private-sector employment and training of unemployed workers could hasten the recovery from the 1981 to 1982 recession. By lowering labor costs, such measures also contribute to reducing inflation.

While acknowledging difficulties with the current targeted jobs tax credit program for the disadvantaged, which relatively few employers have utilized, the Committee believes an effective program can be developed. In its Annual Report of 1981, the Committee made a number of suggestions for restructuring the targeted jobs tax credit to simplify eligibility criteria and certification procedures, eliminate stigmatizing aspects of the program, and increase awareness of it among private employers. A key recommendation is to consider broadening the eligibility categories, so that employers can more readily tell if a job applicant will qualify. Broader criteria, based on earnings and employment status rather than such characteristics as dependence on welfare, might also lead fewer employers to conclude that those targeted by the program are poor employment risks.

B. MONETARY POLICY

Recommendation No. 3: Bring Interest Rates Down and Keep Them Down

The recession of 1981 was caused by unnecessarily tight money and destructively high interest rates. It has

wrought massive damage on housing, the automobile industry, small business, agriculture, productive capital investment, and other productive uses of credit. The Congress, Administration, and the Federal Reserve should concert all efforts to repair this damage, which can be done only by bringing about a lasting climate of lower and more stable interest rates.

Interest rates can and must be brought down and kept down. We reject the view which ascribes the high interest rates of 1981 to inflation alone. High interest rates in 1981 were the direct and predictable consequence of misguided economic policy in 1981. It follows that a change in policy in 1982 can bring interest rates down rapidly and keep them down, and so help bring about a recovery of housing, automobiles, small business, agriculture, productive capital investment, and other vital, interest-sensitive sectors of the economy.

To bring interest rates down and keep them down will require a concerted effort across the policy spectrum—it cannot be done, as some advocate, by a policy of easy money alone. *Inflation* must be brought under control, durably and credibly, so as to eliminate the inflation premium in long term interest rates. A credible anti-inflation policy which does not rely on high interest rates and recession is presented in this Report. The Federal *deficit* must be reduced, particularly in the years from 1983 and after, when we may experience a return of some economic growth. A program to reduce the deficit is presented in this Report. Most important, the relationship between *monetary policy* and *fiscal policy* must be changed. We cannot rely exclusively on monetary policy to fight inflation, and we cannot rely exclusively on fiscal policy to generate growth. A new mix of monetary and fiscal policy measures is presented in this Report. Recommendations 3 through 8 deal with monetary policy; Recommendation 9 through 18 deal with fiscal policy.

The principal objective underlying each of these actions must be the return of an economy in which the small entrepreneur—the businessman, the farmer, the merchant, the inventor, the homebuilder—has a fair opportunity to compete for capital resources at reasonable rates of interest. Restoration of that opportunity should constitute a main goal of economic policy, because it embodies the economic independence which represents the essence of the American system.

Recommendation No. 4: Do Not Tighten Money

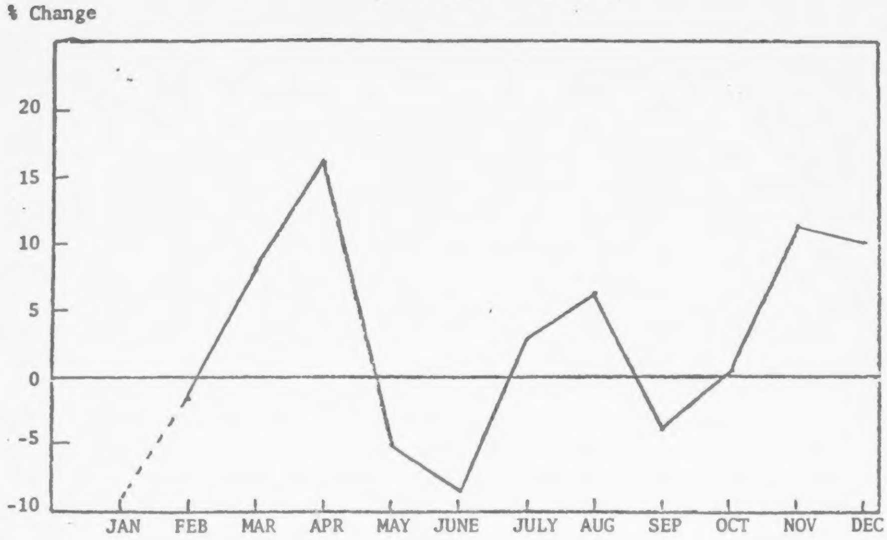
Monetary policy should return immediately to a path of steady, moderate restraint consistent with lower inflation and economic recovery in 1982. Current Federal Reserve plans appear to call for a continued tightening of money this year. Such a tightening would not be consistent with economic recovery under realistic inflation assumptions, and would instead produce a rapid return of intolerably high interest rates soon after the recession abates. A more accommodating monetary policy than currently planned would help bring interest rates down without risking higher inflation.

1981 began with universal agreement between the Administration, the Federal Reserve, and both Democrats and Republicans on this Committee that monetary policy should be, as stated in the first recommendation of our 1981 Report, ". . . moderately restrained to reduce inflation while sustaining steady economic growth." Elsewhere, we have documented the extensive expressions of Administration and Federal Reserve support for this view which this Committee received in the early part of last year. Such a policy, in conjunction with moderate fiscal restraint and a vigoruous program of structural reform, offers the best hope of renewed growth and reduced inflation.

The Administration and the Federal Reserve committed a tragic error in the middle of last year. They abandoned the course of moderate monetary restraint in favor of a high interest rate, deep recession, "cold-turkey" attack on inflation. Table II-4 shows how monetary policy moved abruptly toward a "cold turkey" posture in the spring of 1981. From May through October, growth of M1B was *negative.* More importantly, over the course of the year, the growth rate of M1B was only 2.2 percent, well below the bottom of the Federal Reserve's own target range. The consquences for major interest rates are shown in Table II-5. As one would expect, the sharp change in monetary policy drove interest rates upward, and maintained a prime rate above 20 percent for six consecutive months. The consequences for automobiles sales, housing starts, small business bankruptcies, and real gross national product are shown in Tables II-6 through II-9.

TABLE II-4

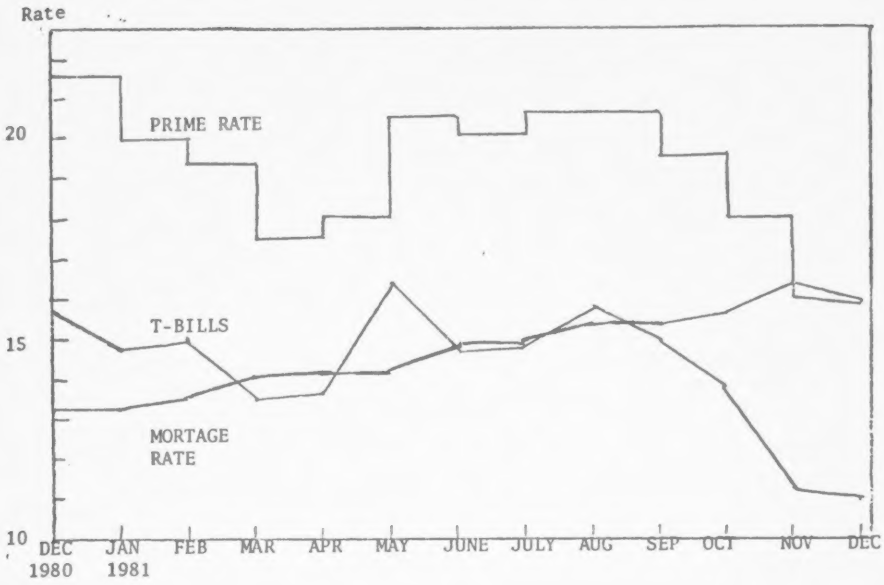
M1-B Shift Adjusted, Monthly Percentage Change, annual rate
(Jan. 1981 - Dec. 1981)



	M1-B Shift Adjusted	% Change
JANUARY	415.5	—
FEBRUARY	415.0	-1.4
MARCH	417.8	8.1
APRIL	423.5	16.4
MAY	422.0	-4.3
JUNE	419.0	-8.5
JULY	420.0	2.9
AUGUST	422.3	6.6
SEPTEMBER	421.0	-3.7
OCTOBER	422.1	.3
NOVEMBER	426.1	11.4
DECEMBER	429.7	10.1

TABLE II-5

Prime Rate, Mortage Rate and 90-Day T-Bill Rate
(Dec. 1980 - Dec. 1981)

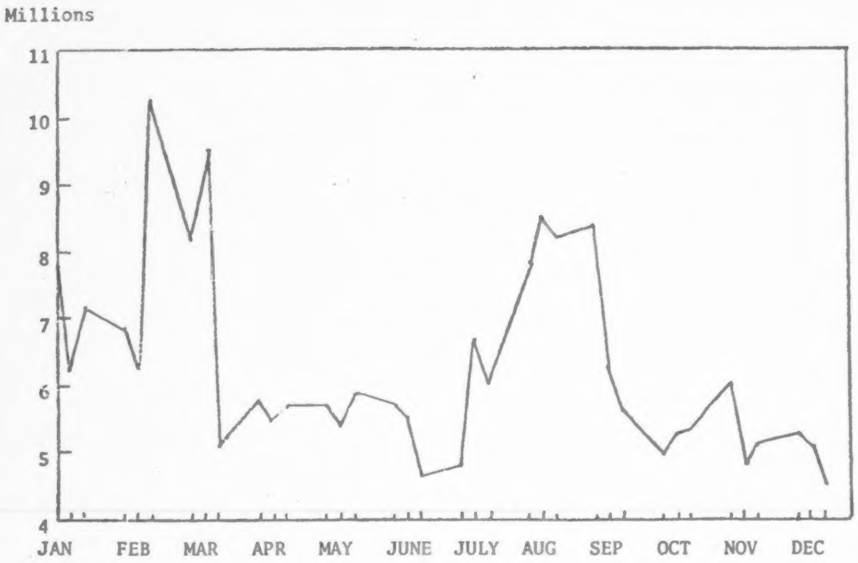


		3-Month T-bills	Prime rate charged by banks	New home mortage yields
1980	DEUEMBER	15.661	17 3/4-21½	13.28
1981	JANUARY	14.724	21½-20	13.26
	FEBRUARY	14.905	20-19	13.54
	MARCH	13.478	19-17½	14.02
	APRIL	13.635	17½-18	14.15
	MAY	16.295	18-20½	14.10
	JUNE	14.557	20½-20	14.67
	JULY	14.669	20-20½	14.72
	AUGUST	15.612	20½-20½	15.27
	SEPTEMBER	14.951	20½-19½	15.29
	OCTOBER	13.873	19½-18	15.65
	NOVEMBER	11.269	18-16	16.38
	DECEMBER	10.926	15 3/4-15 3/4	15.89

Source: Economic Indicators

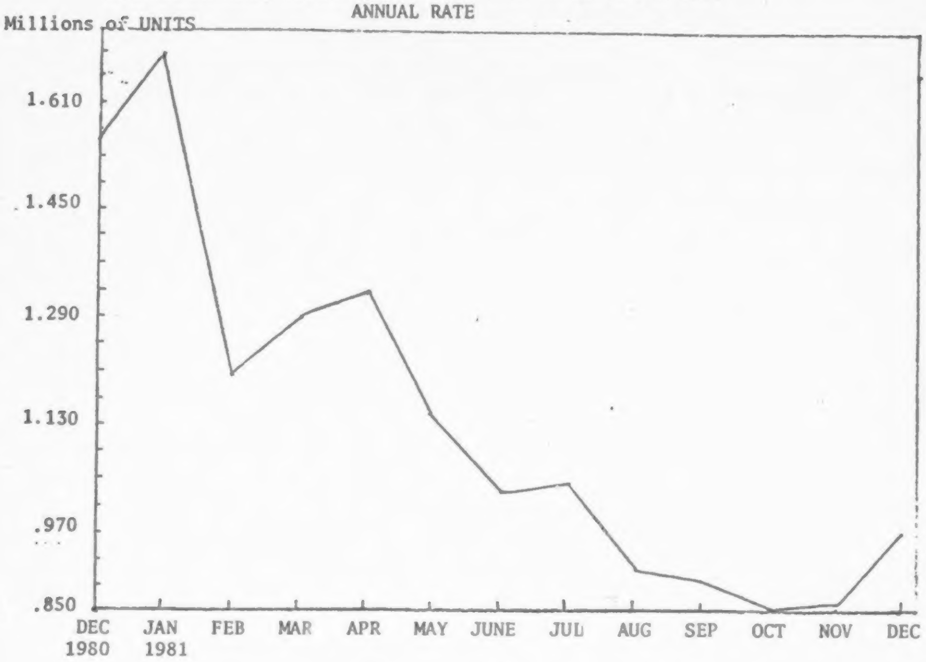
TABLE II-6

(1981)
10-Day Domestic New Car Sales
(Seasonally Adjusted Annual Rate)
(Millions)



	(Millions)		
	1	2	3
JANUARY	7.8	6.3	7.2
FEBRUARY	6.9	6.3	10.3
MARCH	8.2	9.6	5.1
APRIL	5.8	5.5	5.7
MAY	5.7	5.4	5.9
JUNE	5.7	5.5	4.7
JULY	4.8	6.7	6.0
AUGUST	7.8	8.5	8.2
SEPTEMBER	8.4	6.3	5.6
OCTOBER	5.0	5.3	5.3
NOVEMBER	6.0	4.8	5.1
DECEMBER	5.3	5.1	4.5

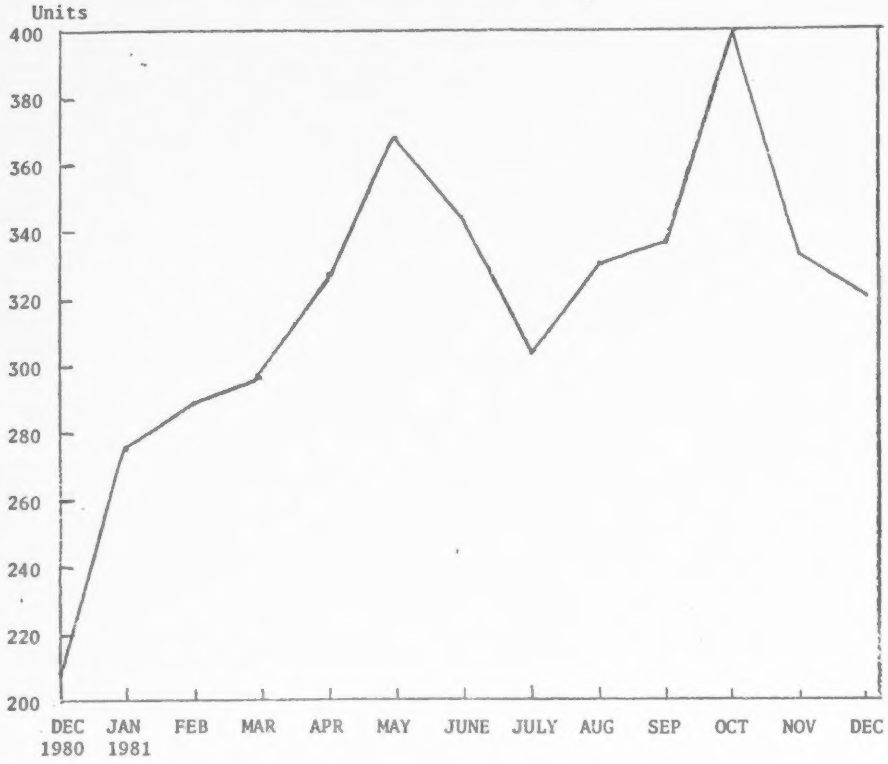
TABLE II-7
HOUSING STARTS, MONTHLY, DECEMBER 1980 TO DECEMBER 1981
ANNUAL RATE



1980	DECEMBER	1.535
1981	JANUARY	1.660
	FEBRUARY	1.215
	MARCH	1.297
	APRIL	1.332
	MAY	1.158
	JUNE	1.039
	JULY	1.047
	AUGUST[r]	.941
	SEPTEMBER[r]	.920
	OCTOBER[p]	.857
	NOVEMBER[r]	.860
	DECEMBER[p]	.970

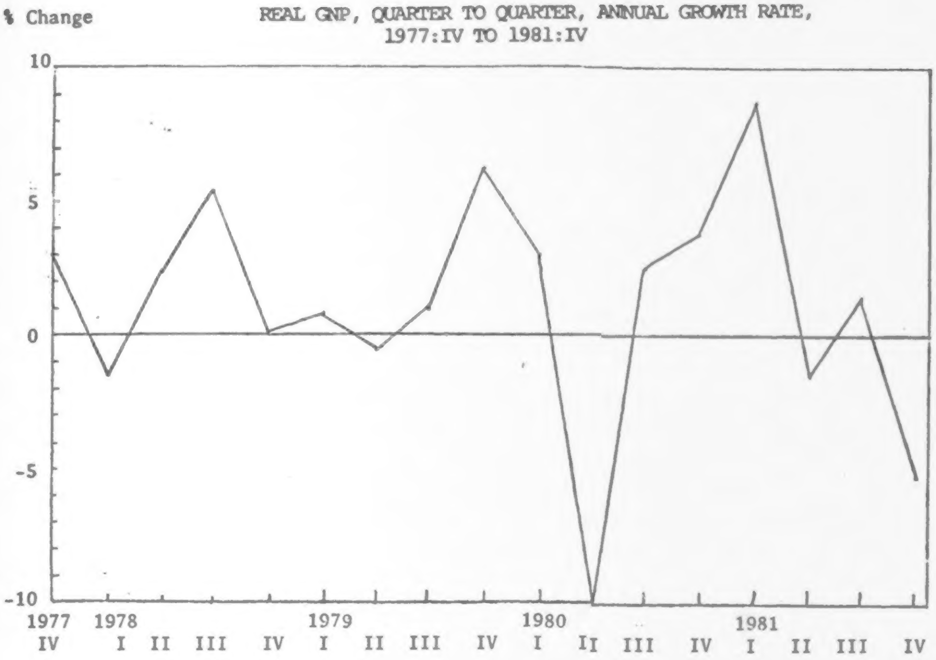
TABLE II-8

Average Weekly Business Failures for Each Month (Dec. 1980 - Dec. 1981)



		WEEK					
		1	2	3	4	5	AVERAGE
1980	DECEMBER	190	282	195	212	174	211
1981	JANUARY	250	344	293	221		277
	FEBRUARY	372	321	232	236		290
	MARCH	345	319	291	236		298
	APRIL	249	282	393	407	309	328
	MAY	351	434	394	291		368
	JUNE	344	312	368	349		343
	JULY	292	224	313	336	346	302
	AUGUST	354	349	335	280		330
	SEPTEMBER	304	309	391	343		337
	OCTOBER	481	468	284	307	459	400
	NOVEMBER	381	288	456	206		333
	DECEMBER	443	367	391	216	178	319

TABLE II-9



REAL GNP, QUARTER TO QUARTER ANNUAL GROWTH RATE
1977 IV - 1981 IV

1977	IV	3.0
1978	I	-1.6
	II	2.5
	III	5.4
	IV	.2
1979	I	.7
	II	-.5
	III	1.2
	IV	6.1
1980	I	3.1
	II	-9.9
	III	2.4
	IV	3.8
1981	I	8.6
	II	-1.6
	III	1.4
	IV	-5.2

In the President's Economic Recovery Program of February 18, 1981, the Administration advocated a path for monetary policy over the next six years:

> To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986.

The growth rate of M1B in 1980 was 7.3 percent. Therefore, a path of deceleration which would have been consistent with the Administration's February 18, 1981, policy assumptions would have implied a reduction of M1B growth of about 0.6 percent per year for six years. This would also have been roughly consistent with the Federal Reserve's own monetary growth targets of 4.0 to 6.5 percent for 1980, and hence with our recommendation last year that the 1980 target range be maintained in 1981.

Instead, the Federal Reserve reduced its target ranges for M1B from 4.0 to 6.5 percent in 1980, to 3.5 to 6.0 percent for 1981. And, with full Administration support, it tightened policy from May onward so as to undershoot the bottom of that newly tightened target range. Actual M1B growth from the fourth quarter of 1980 through the third quarter of 1981, adjusted for shifts into "other checkable deposits" from nondemand deposit sources, was at an annual rate of only 1.3 percent—a rate less than half that which the Administration originally intended that the Federal Reserve achieve in 1986.

In November and December of 1981, for technical reasons, including the fact that the Federal Reserve partly accommodated a surge of distress borrowing, M1B recovered somewhat, while interest rates rose. Fourth quarter 1980 to fourth quarter 1981 M1B growth came to 2.2 percent. This action, which brought M1B growth back toward the bottom of its target range for the year as a whole, was clearly a response in the correct direction to a badly deteriorated situation, and it showed the inherent countercyclical value of continuing to specify monetary growth objectives on an annual basis. Nevertheless, it did not signify the easing of monetary policy which is needed, nor did it pervent interest rates from rising.

Now, for 1982, the Federal Reserve has announced a further reduction in the target growth range for M1B to 2.5 to 5.5 percent. This further reduction seems to mean that the Federal Reserve intends to tighten money again in 1982. This is particularly clear, in view of the very low fourth-quarter 1981 base from which the 1982 M1 range departs. Given the realized M1B growth of 2.2 percent in 1981, even achievement of the upper third of the Federal Reserve's 1982 range, or 4.5 to 5.5 percent growth, which the Administration supports, would mean an average monetary expansion over the two-year period 1980:IV to 1982:IV of only 3.3 to 3.6 percent per year—far less than the Administration's own early 1981 mandate to the Federal Reserve and far too low to finance any significant economic recovery. Achievement of the lower end of the range, 2.5 percent, would be a cumulative expansion averaging only 2.3 percent over the two years.

The 1982 targets thus send a clear and unwelcome signal that the policies of the Administration and the Federal Reserve may not permit significant economic recovery for the interest-sensitive sectors of the economy this year. If it appears, as a result of the 1982 personal income tax reduction which was passed last year and the increase in spending for armaments which is now underway, that demand is reviving for new homes, for automobiles, for the small business sector, and for productive capital investment, the inevitable consequence of the policies that have been announced will be a return to high and rising interest rates. The return of rising interest rates—which may have already begun—would renew and deepen the already profound misery of these vital sources of our national economic strength.

We recommend that the Federal Reserve and the Administration return to the path of moderate monetary growth which all appeared to endorse a year ago. Such a policy should be designed to permit economic expansion in 1982, and should be combined with policies to ensure that inflation continues to decelerate. A clear signal of such a return to monetary moderation would have been a decision by the Federal Reserve to maintain its monetary targets for 1982 at their 1981 levels, and specifically that the target for M1 be maintained at 3.5 to 6.0 percent.

Recommendation No. 5: Low Real Interest Rates Should Be the Immediate Goal

Real interest rates in 1981 were kept high by policy as inflation fell. The Federal Reserve, Administration, and the Congress should agree on the immediate objective of restoring low real interest rates, defined as bringing long-term interest rates back to their historical relationship with the current and expected rate of inflation. If inflation continues to decline, policy should bring long-term interest rates down rapidly, to prevent real interest rates from rising.

There are those who attempt to excuse the deplorable performance of economic policy in 1981 by attributing the high interest rates and subsequent recession to the effects of inflation. This view is nonsense. Inflation fell in 1981, as a result of a weak oil market, good crop harvests, and the recession, from 12.4 percent in 1980 to 8.9 percent in 1981. Yet, interest rates rose. Thus real interest rates—measured as the difference between nominal interest rates and the rate of inflation—rose sharply, even more sharply than nominal interest rates. Real interest rates are an unambiguous measure of the effect of monetary policy on the economy. Ironically, many of those who now attribute 1981's high interest rates to monetary volatility—and therefore argue that interest rates cannot be brought down—were among the same people who a few months ago would argue that real interest rates were low (specifically, that nominal interest rates were close to the expected rate of inflation), in support of the argument that nominal interest rates could not fall until inflation had been brought down.

On June 17, 1981, Chairman Murray Weidenbaum of the President's Council of Economic Advisers testified:

> It's my understanding . . . that the high inflationary expectations are the driving factor for the high interest

rates. As we continue to bring down the inflation, interest rates should fall.

Inflation and inflationary expectations have now been brought down. Nominal long-term interest rates should be brought down immediately to their historical relationship with inflation, thus restoring real interest rates to survivable levels. If inflation falls further, nominal interest rates should be reduced promptly as well.

Recommendation No. 6: Practice Credit Conservation

> **The Administration and the Federal Reserve should encourage the banking system to develop an effective means to deter destabilizing bursts of bank-financed lending for unproductive purposes such as large corporate takeovers and speculation in commodities, collectibles, and land. Such measures will have the effect the conserving scarce credit resources in times of need for the use of small business, farmers, housing, automobile financing, and productive capital investment.**

1981 was a banner year for predacious corporate takeovers financed by the savings of ordinary American citizens. Spectacular examples included the takeover of Conoco by DuPont, after a public battle involving Texaco, Mobil, and Seagrams, the takeover of Marathon Oil by U.S. Steel, after a public battle with Mobil, and the attempted takeover of Grumman by LTV. One can only imagine how millions of ordinary Americans who could not get credit in 1981 viewed the spectacle of such massive misuse of their savings by the corporate world and the banking system.

In a climate of very tight money, such as prevailed in 1981, large-scale bank lending for mergers and other speculative activities unrelated to economic efficiency add to pressures on interest rates in several ways. First, before the takeover, lines of credit are extended, often to more than one potential buyer of a target corporation, often by more than one major bank. These lines of credit can prevent tens of billions of dollars from becoming available to ordinary borrowers for a short period of time. When the takeover is consummated, one line of credit (that of the acquiring company) is drawn down, and the others are released. This ties up a smaller amount of money, but often for a longer period of time. Finally, when the shareholders of the target company are paid off, they receive a windfall gain, relative to the market value of their shares before the takeover battle began. Some of this windfall is saved and thus available for relending, but some is consumed, and therefore disappears from the national stock of saving. All of these forces apply upward pressure on interest rates.

In October 1979, the Federal Reserve took steps to discourage bank lending for nonproductive purposes, including commodity speculation and purely financial activities, such as corporate takeovers. At that time, Chairman Volcker acknowledged that such activities compete with small business, productive capital investment, homebuyers, and farmers for scarce credit resources, and can have the effect of driving up interest rates to the detriment of these productive and desirable activities.

Since the end of the credit control program which replaced the October 1979 guidelines in March of 1980, however, the United States has been without a policy to discourage bank lending for speculative and takeover purposes. Such a policy is badly needed.

We recommend specifically that a policy in this area take the form of *credit conservation,* and that it not involve massive, bureaucratic, and ultimately futile efforts at *credit allocation.* We should effectively discourage bank lending for those few uses which conspicuously absorb large amounts of scarce credit to the detriment of more productive uses. This will not put an end to corporate takeovers. But it will make them more expensive to the acquiring firm, and therefore encourage a reallocation of that firm's efforts to more productive activity, which is the point. We should not attempt to devise methods to allocate credit directly to one broad sector of the economy or another, since such efforts merely create market incentives to thwart the allocative mechanism while collecting any subsidy which may be offered.

Many alternative mechanisms for credit conservation are possible. One was recommended to the Committee by a distinguished retired banker, Gaylord Freeman of the First Chicago Bank, in testimony on June 1, 1981. Under Freeman's proposal, a special antitrust exemption would be given to banks on occasions designed by the Federal Reserve Chairman to enable them to cooperate in complying with a Federal Reserve guideline against corporate takeover or commodity speculation loans for a specified period of time. We believe that the Freeman proposal deserves serious consideration.

We also note that such credit conservation is fully consistent with the economic philosophy of this Administration. The case to that effect was made before the Committee on September 17, 1981, by Professor Walter W. Heller, who said:

> Although one shies away from direct credit controls, a few words to the wise from the Federal Reserve Board to the banking community could help conserve the existing money supply and direct it to productive rather than nonproductive investment. Surely, an Administration that has no hesitation in providing multiple tax guides to investment, savings, and the like should not find it inconsistent to go along with some credit guidance.
>
> The Chairman of this Committee put it succinctly and well when he said on the Floor of the House last July 28: "All branches of government ought to encourage our banking industry to soft-pedal loans for commodity speculations, for corporate takeovers, for excessive foreign lending, and thus encourage more money to be available, and at lower interest rates, for housing, construction, capital investment, farmers, small business, and the thrift institutions."
>
> This approach can logically be thought of as the counterpart to the tax guidance so liberally practiced by the White House and the Congress in the Economic Recovery Tax Act of 1981, the most deliberately unneutral tax act in the country's peacetime history . . . To guide into constructive and productive uses the loanable funds generated

> by Federal Reserve policy is surely no greater interference with private market resource allocations than the powerful tax guidance encoded in the tax act.

The Administration has not hesitated to advocate tax guidance. It should face up to the need for credit guidance as well.

Recommendation No. 7: End the Interest Rate Wars

> **In 1981, U.S. high interest rates damaged the world economy and undermined confidence in the economic leadership of the United States. These severe international repercussions must not be allowed to continue. High interest rate competition should be replaced by much closer international coordination of economic policy.**

1981 was a year of distress and dismay for America's friends in Europe and the third world: distress because the level of American interest rates exported inflation and recession abroad, and dismay because of the evident indifference of the Administration to the international consequences of its policies. The United States was, in effect, the aggressor in an interest rate war waged against our own most loyal and valued friends.

When interest rates rise in the United States, the effects are felt around the world. The international integration of world capital markets makes it virtually impossible for our allies to escape the consequences. There are two distinct effects. First is a contractionary effect: interest rates abroad rise in response to the outflow of capital generated by rising U.S. interest rates, and this depresses investment, small business, agriculture, and other interest-sensitive sectors of foreign economies just as it does at home. Second, there is an inflationary and contractionary effect, because, to the extent that the movements of U.S. interest rates are not entirely and immediately matched abroad, the dollar will appreciate relative to foreign currencies. This raises the domestic price of imports denominated in dollars, of which the most significant for Europe and Japan is oil. Thus, a rise in our interest rates affects our friends and allies in exactly the same way that a rise in OPEC oil prices affects us: it is a supply shock which simultaneously boosts inflation and drains demand from their economies. It is also a highly visible sign of our Administration's official indifference to the economic interests and sensitivities of our allies.

In testimony before the Committee at a hearing on international economic policy on May 4, 1981, Dr. Pentti J. K. Kouri explained the effect of the Administration's policies on Europe in general and Germany in particular:

> Internationally, the high level of interest rates in the United States has brought renewed strength to the dollar in the foreign exchange markets and, at the same time, it has presented the European central banks and government with a difficult policy choice.
>
> Consider the case of Germany. The domestic economic situation clearly calls for monetary policy that is supportive of recovery, particularly in view of the fact that domestic inflationary pressures are well under control. The defi-

> cit in the current account, which has prevailed for the German mark in real terms, unless it is viewed as purely temporary, in which case the appropriate policy would be to finance it by an inflow of capital.
>
> The high level of interest rates in the United States makes the financing possible only if the expected rate of return on Deutsche mark claims is competitive with the expected return on U.S. dollar assets. Equality of expected rates of return could be obtained if the German mark depreciated to such a low level that it would have to appreciate from then on at a rate equal to the difference in interests rates between Germany and the United States. But this policy option . . . would add to domestic inflationary pressures. The other alternative is to raise the level of domestic interest rates . . . at the cost of output and employment objectives of macroeconomic policy . . .
>
> Continuation of high real interest rates in Germany and other countries of continental Europe prolongs the already severe economic slowdown whilst further currency depreciation would worsen the inflation situation.
>
> This explains the European call for a coordinated reduction in the level of interest rates world wide.

This Committee warned last year against the dangers of a renewed interest rate war. We recognize that a prolonged recession in the United States might remove some of the pressure on worldwide interest rates, since it could permit U.S. interest rates to fall while reductions in domestic demand reduce imports, add to the current account balance, and so prevent a depreciation of the dollar. But this clearly is not a sure or permanent solution. Rising interest rates may persist whether or not we have a recovery; they will surely return if there is an early recovery, as the Administration predicts, and if monetary and fiscal policies are not changed.

Therefore, we once again urge the Administration to pay heed to the calls of our allies for better macroeconomic policy coordination. An improved mix of fiscal and monetary policy, which is desirable as well for purely domestic reasons, would demonstrate our concern and good faith.

Beyond that, the Administration should embark on a concerted program of negotiations to assure macroeconomic policy coordination with our major allies, both at and between economic summits.

Recommendation No. 8: Improve Federal Reserve Accountability and Policy Coordination

For the past decade, evidence has mounted that there are fundamental flaws in the procedure of monetary policy formation and oversight. These flaws were only partly corrected by the shift from interest rate to monetary targeting in October 1979; indeed, that change has brought new difficulties to the fore. We call for the Federal Reserve to take a fresh look at the formation of monetary policy and report to the Congress. Such a report should have six specific objectives:

To improve the quality of information about monetary policy objectives made available to the Congress and the public;

To improve the coordination of monetary policy, fiscal policy, and other tools of economic policy;

To provide guidelines for the conduct of monetary policy in times of rapid financial innovation and change in monetary instruments;

To provide guidelines for the conduct of monetary policy in the face of supply shocks;

To evaluate the instability in recent years of the demand for money, and recommend changes in monetary policy procedures that may be necessary as a result of this development; and

To devise ways to guarantee that Federal Reserve policy takes full account of the legitimate interests of industry, agriculture, and commerce, including small business and housing, as stipulated in the Federal Reserve Act.

1981 was a year of emerging dissatisfaction with the procedures of monetary policy formation and oversight. It has become clear that the current system of multiple aggregate monetary targeting does not provide an adequate guide to the complexities of the current monetary environment, or an adequate yardstick by which the measure the success or failure of the Federal Reserve's performance. On the other hand, no plausible alternative to the present system has been articulated and given a full professional review by competent specialists. We therefore recommend that the Federal Reserve undertake the task of developing necessary improvements in the process of monetary policy formation and oversight.

The two principal objectives of monetary policy reform must be to provide for accountability of the Federal Reserve System and for the coordination of monetary policy with fiscal policy, incomes policy, and other initiatives of the Executive branch and the Congress. The present system serves neither objective. For reasons which will be discussed below, the system of annual reporting of monetary growth targets no longer provides an adequate gauge of Federal Reserve performance if it ever did; a new system must be designed which holds the Federal Reserve more closely accountable for the ultimate objectives of growth, employment, and price stability, without sacrificing the quality of information available to the Congress. As for policy coordination, that presently depends on the personal chemistry between the Chairman of the Federal Reserve Board, the President, and the Congress. A sound institutional basis for coordination is urgently needed.

We continue to support the objectives of the monetary policy reforms of the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978, as well as the change in Federal Reserve monetary policy procedures from interest rate to monetary growth targeting in October of 1979. The Humphrey-Hawkins law codified a procedure under which, for the first time, the Federal Reserve was required to present to the Congress its monetary policy objectives at the beginning of each year. These objectives were formulated in terms of targets for the growth rates of various monetary aggregates on the fourth-quarter to fourth-quarter basis. These targets, together with the forecasts of real GNP, inflation, and unemployment which the Federal Reserve has supplied the Congress since 1975, have provided the Congress with a useful body of information about the Federal Reserve's intentions, and in calm monetary seasons have served as a reasonable yardstick of performance.

The change in targeting procedures in October 1979 was also a sensible one, because it corrected a long-standing defect in the Federal Reserve's response to cyclical changes in the economy. Under short-term interest rate targeting, the Federal Reserve had shown a tendency to act procyclically—to hold interest rates down and so aggravate inflationary pressures in times of high demand, and to keep interest rates up and so retard recovery in times of recession. Under monetary targeting, in theory, interest rates would be allowed to rise in inflationary booms, and to fall rapidly in recessions, and so monetary policy would contribute another "automatic stabilizer" to the arsenal of fiscal stabilizers already built into the system.

We now know, however, that conditions can arise under which simple monetary targeting rules do not provide a good guideline for the conduct of monetary policy. In the case of supply-side shocks, such as a sharp rise in the price of oil, rigid adherence to a preordained monetary growth path transmits all of the shock rapidly into a fall of output and employment, which is desirable only if one regards the unemployment rate with disinterest, which we certainly do not. Last year, we wrote in our Annual Report for 1981 as follows:

> Sudden supply shocks—such as the surge of oil prices in 1979 and 1980—can be a particularly damaging source of short-run deviation from the target rates of growth of money and credit. Such shocks, if no accompanied by an increase in the velocity of money, impose real costs on the economy which cannot and should not be offset completely by monetary expansion. But to err the other way, and to attempt to maintain too rigid a short-run money growth path in the face of an oil shock (for example) could mean sky-high interest rates, lost output, and unemployment. Neither extreme is desirable. The Federal Reserve should partly accommodate supply shocks in the short run, while working toward control over money and credit growth over time.

As it happened, there were no significant supply shocks to monetary policy and the economy in 1981. Nevertheless, other events did occur, with equally serious ramifications for monetary policy procedures.

The most important such event was the introduction in 1981 of nationwide NOW accounts, the rapid growth of checkable money market mutual funds, and other forms of financial innovation. The Federal Reserve responded to these events, which generated a large additional surge of M1B in April of 1981 as funds flowed in from the higher monetary aggregates to interest-bearing checkable deposits, by subtracting such flows and publishing a "shift-adjusted" M1B. The estimate of shift-adjusted M1B assumed that 22.5 percent of flows into Other Checkable Deposits in January and 27.5 percent in subsequent months came from nondemand deposit sources.

We have no particular objection to the Federal Reserve's adjustment method, nor any complaint with the estimate of shift-adjusted M1B the Federal Reserve derived. We merely note that derivation of "shift-adjusted" M1B represents at best an approximation—a "best guess." And a different estimate would have had a dramatic effect on the estimate of M1B and, hence, under the monetary targeting rule in effect, different implications for the conduct of monetary policy. Yet, no systematic procedure exists under which the Federal Reserve must report on and justify such abrupt redefinitions of the monetary target on which it is operating.

Instability of money demand has also emerged as a serious issue for the conduct of monetary policy. Misestimation of the money demand functon can mean that a given monetary target has effects on the real economy which are more restrictive—or more expansionary—than the monetary authorities intend. In recent years, such misestimation has become common, and has been offered by some as a phenomenon which partly explains how a change in monetary policy procedures intended to be stabilizing can have destabilizing consequences on output, employment, and inflation.

A particularly important shift in money demand may occur if the public adopts durable expectations of lower inflation in the future. In such a case, money demand may rise, as individuals see the benefits of relative liquidity coming to outweigh the declining opportunity cost of holding a noninterest bearing asset. A monetary target which fails to take into account this shift in expectations will prove to be too restrictive in practice, driving up interest rates and causing unemployment, when in fact no excess demand in final goods markets exists. There is no way at present to foresee or measure such shifts in inflationary expectations. Thus, to the extent the monetary authorities are operating under a long-range schedule for deceleration of predefined monetary aggregates, as the Administration has recommended, the Nation is under a Damocletian sword of potential future excess restraint.

In our last Annual Report, we argued that the Federal Reserve's procedures for monetary control could be improved, and the danger described above lessened, if the Federal Reserve were to undertake a careful, public, annual exercise of linking its targets for the monetary aggregates to the state of the economy at the time the targets are set. We wrote:

> The Federal Reserve should calculate its targets each year on the basis of its long-run noninflationary money growth objective and on the state of the economy. For example, a technique could be to begin by adding to the potential growth rate of real GNP some part of the inflation rate which cannot be avoided in the forthcoming year (taken as the core rate of inflation, the underlying trend of inflation when the effects of excess demand and supply shocks have been taken out). From that value, one could

> subtract any expected rate of increase of the velocity of money. The benchmark value derived using this option would imply a monetary policy that accommodates the economy's real growth potential and the existing core rate of inflation. If the Federal Reserve believes that a more restrained or a more stimulative policy would be called for, it should so indicate, giving its reasons.
>
> The Federal Reserve should undertake this exercise annually, adjusting its targets to reflect changes in our real growth potential, our core rate of inflation, and in the demand for money—i.e., in the income velocity of money. The Federal Reserve should explain to Congress the influence of changes in each of these factors on the targets which it is presenting. Such careful linking of the annual monetary targets to the real growth potential and to core inflation will increase the credibility of the targets and of the Federal Reserve's anti-inflationary policy, and it will help focus attention on the long-run nature of the Federal Reserve's objectives for money and credit.
>
> In setting its monetary targets, the Federal Reserve should be especially alert for changes in the velocity of money. These alter the relationship between money growth and nominal GNP, and so determine whether a given monetary target is restrictive or expansionary in its effect on the economy. When money velocity increases, it is appropaite to lower the target ranges in order to maintain an equivalent degree of restraint, and conversely when money velocity falls.

We continue to believe that such an exercise of explanation would be helpful, and would help the Federal Reserve to escape from dogmatic commitments to particular arithmetical objectives which may be ill-advised. Nevertheless, we are now persuaded that this alone may not be enough. There is a clear case for a fundamental review of the entire process of monetary policy formation and its oversight by the Congress. We believe that the Federal Reserve, by undertaking to study and report on the issues listed above, could contribute significantly to the revitalization of our monetary policy process and to the reestablishment of the credibility of and support for the Federal Reserve System.

Recommendation No. 9: Very Short-Run Money Volatility Is Not A Problem

> **We disagree with the view that very short-run volatility of money growth significantly damaged the economy in 1981. We urge that this criticism of the Federal Reserve be dispensed with.**

In early 1981, the Administration stipulated repeatedly and extensively its analysis of the flaws of monetary policy in the past and its prescription for monetary policy in the future. The analysis was plain: money growth in the past had been too rapid. As Secretary Regan testified on February 19, 1981:

> Stable prices are impossible if the rates of money growth exceed the growth rate of goods and services, as they have done on average for more than a decade.

The prescription was also plain: money growth should be slowed, slowly and consistently over a period of years. Although the Administration frequently used such qualifiers as "steady" and "consistent' to describe the monetary policy they desired, they made it clear that these referred to the multi-year period for which they were prescribing monetary policy as a whole, and not to money growth volatility in the extremely short run. This emerged in a colloquy between Secretary Regan and Chairman Reuss on February 19, 1981. Chairman Reuss had based his question on an inference from Secretary Regan's testimony that the Administration had given a specific instruction to the Federal Reserve for the conduct of monetary policy in 1981:

> Representative REUSS. I am simply asking, are you sure that the Administration is right in telling the Fed now in 1981 that it ought to get the money supply down to 1 percent, the growth rate (of real GNP) that you predict . . .?
>
> Secretary REGAN. The President is suggesting that for the out years, not this particular year. We have not told the Federal Reserve any particular target. We would not; they are an independent body . . . What the President was suggesting was for the out years, 1982 to 1984 and the like—where we are projecting 4 to 5 percent real growth in GNP, that the money target should be in that range.
>
> Representative REUSS. Even there, is he now suggesting that for 1982—admittedly, that is nine months off—we ought now to determine that we are going to cut the present rate of monetary growth by one-third, from 6 to 4 percent?
>
> Secretary REGAN. No. What he is suggesting—we are on the road going there. We can't go overnight. We can't turn it off like a faucet. What he is suggesting is that is an ultimate target, rather than a short-range target or even, indeed, an intermediate target. It is our long-range goal that the President is suggesting should be the Fed's course of action.

As 1981 progressed, the Administration came firmly to the support of the tight money, high interest rate policy which was put into effect by the Federal Reserve. On April 8, 1981, Treasury Undersecretary Beryl Sprinkel testified before the Subcommittee on Monetary and Fiscal Policy, chaired by Senator Jepsen:

> . . . we applaud and support wholeheartedly a long-term monetary program which will lead to a steady, predictable, and appropriately slow rate of monetary expansion. . .
>
> . . . we are supportive of the Federal Reserve's stated intent to reduce growth in the monetary aggregates. The monetary excesses of the past 15 years cannot be corrected quickly and the Federal Reserve's stated intention for 1981 is a prudent first step.

Undersecretary Sprinkel did address the question of short-run volatility in the monetary aggregates, saying:

> Obviously, strict control over money growth from month to month is not possible given the current financial structure, and random variability is to be expected. On the other hand, systematic deviations from the target path which persist for several months can be avoided.

Nevertheless, this criterion had provided no grounds for criticism of the Federal Reserve up to that point, as the following colloquy shows:

> Representative REUSS. Has the Federal Reserve (since you have been in office) performed satisfactorily as far as you are concerned?
>
> Dr. SPRINKEL. I think so. There has been a significant slowing in monetary growth since last fall.

In the months that followed, beginning in May 1981, the Federal Reserve brought the growth of the narrowly defined money stock, M1B, down, sharply and abruptly. M1B growth from May through October was actually negative; on a first-quarter-to-third-quarter basis, the annual growth rate for M1B was 1.3 percent. Interest rates shot up, and stayed up. The consequence, a steep recession, began in July.

Given the preference for a gradual, steady deceleration of money growth over a period of years which it had clearly articulated to this Committee, the Administration would have been entirely justified in June, July, August, September, and October in criticizing the Federal Reserve for a too rapid, over-zealous, unnecessary crackdown on the money supply. The Administration did not do so. On the contrary, Administration officials appearing before this Committee repeatedly and consistently endorsed the tight money, high interest rate policy of the Federal Reserve.

On June 17, 1981, Chairman Murray Weidenbaum appeared at a hearing of the Subcommittee on Trade, Productivity, and Economic Growth, chaired by Senator Roth. His testimony included the following exchange with Senator Abdnor:

> Senator ABDNOR. Increasing productivity is necessary and important, and I support efforts to promote productivity growth, but with high interest rates our efforts will not be effective.
>
> Chairman WEIDENBAUM. It's my understanding, Senator, that the high inflationary expectations are the driving factor for the high interest rates. As we continue to bring down the inflation, interest rates should fall. We have already seen the beginnings of at least a temporary and hopefully a longer term decline in interest rates. I can't give you a pinpoint forecast, but it is my expectation that, as inflation continues to unwind—because of the monetary and fiscal restraint we have embarked upon—we will see inflation coming down and continue to come down, with inflationary expectations coming down, and further progress in bringing down those painfully high interest rates, which is our objective.

On September 24, 1981, Dr. Jerry Jordan, a member of the President's Council of Economic Advisers, testified before the Committee and reaffirmed the Administration's support of Federal Reserve policy:

> Representative REUSS. Where, in your judgment, is the Federal Reserve going astray at the present time?
>
> Dr. JORDAN. I don't believe they are going astray. . . . We think that the long-term effect of relatively slow monetary growth is going to decline in both short-term and long-term interest rates, but we were aware that short-term interest rates had to decline first. We were concerned that people might misinterpret declining short-term interest rates as being a caving-in on the will to fight against inflation, and I don't believe that that is the correct interpretation at all.
>
> We expect interest rates to decline the rest of this year and all of next year, but we don't think that that should signal that we are not as determined to fight against inflation or that the Federal Reserve is not persisting in its anti-inflation policies.

On October 7, 1981, Chairman Weidenbaum testified before the Subcommittee on Economic Goals and Intergovernmental Policy, at a hearing on "The Defense Buildup and the Economy." Chairman Reuss and Dr. Weidenbaum had this exchange:

> Chairman WEIDENBAUM. I can assure the Chairman . . . of the constancy of our monetary and fiscal policy. From the outset, we have stated a steady and slow rate of growth in the money supply in contrast to the excessive inflationary pace of recent years is a very necessary objective of our economic program, and we have suported and continue to support the Federal Reserve's efforts to achieve that steady and moderate growth in the monetary aggregates.
>
> Representative REUSS. Now it's tempting to jump on the Fed and say their M1B is below their target and they'd better rev it up. Do you, therefore, speaking as a private person, think that the Fed should now rev up M1B?
>
> Chairman WEIDENBAUM. Speaking as a member of the Administration, I don't think the Fed should rev up. I think the Fed should continue to follow its announced policy of monetary restraint which is the policy we have steadily supported from the outset of this Administration. I am mindful of the difficulties in so calibrating the specific movements of the various monetary aggregates to achieve those targets, but I strongly support the targets established by the Fed.
>
> But more important than the specific numbers, I think, is the underlying policy that we will continue to make progress, as we have so far this year, in reducing the rate of inflation by following a steady, consistent policy of monetary restraint and that, of course, has been the consistent statement of the President going back to his comprehen-

> sive campaign statement in Chicago back in September, through the February White Paper where we enunciate our economic and monetary policy, and continuing through statements to this very day.

On October 28, 1981, David Stockman, Director of the Office of Management and Budget, testified before the Subcommittee on Monetary and Fiscal Policy, chaired by Senator Jepsen, at a hearing entitled "Government Competition with Small Business." In response to a question from Chairman Reuss, Director Stockman said:

> . . . yes, in the last several months M1B has been coming in at a very low rate. It seems to me, (that) you, who have been one of the great experts in Congress for many, many years, (would) recognize that with the enormous change and innovation occurring in the financial markets today that a measure of one money variable, of M1B, especially being affected by changes in financial deposit practices for only a few weeks or a few months doesn't really tell the whole story.
>
> If you assume that M1B is still a valid measure of what we would call transaction deposits in the economy, I would at least suggest that we look at a year or at least the last nine or ten months. In that case, the growth rate has been about 5 percent which is geared to the target, and I think not unduly low.
>
> So what we see is that, rather than an excuse for changing the monetary policy, instead, the monetary policy is working. Inflation is coming down. The inflationary pressure is being squeezed out of the economy. If we want to reduce the burden of these currently prohibitive interest rates on small business and all other business for that matter, it seems to me what we ought to do is not quarrel with the monetary policy which is correct, but address the problem which we are jointly responsible for, and that is the fiscal policy, the budget, and the deficit, and work in every way we can devise to get the Treasury borrowing requirement reduced.

The next senior Administration official to appear before the Committee was Treasury Secretary Donald Regan, who testified on January 27, 1982. By that time, the depth and severity of the recession were better known: unemployment had risen sharply in October, November, and December after having been relatively stable through the early fall, and real output in the fourth quarter of 1981 had fallen at an annual rate of over 5 percent. Somewhat paradoxically, demand for money rose sharply at the end of the year, a phenomenon which may be partly explained by a drop in corporate profits, which generates a distress-based demand for credit to provide cash flow. This demand had been partly resisted and partly accommodated by the Federal Reserve, with the consequence that interest rates, which had fallen in October and early November, turned around sharply and started again to rise, while at the same time, month-over-month growth of M1B resumed.

Most important, by late January, it was almost universally agreed that the recession was uniquely the consequence of the tight money and high interest rate policy pursued by the Federal Reserve, with Administration support, consistently throughout 1981. On January 19, 1982, three Nobel Laureates in Economic Science testified before the Committee. All agreed on this fundamental point. Professor Wassily Leontief testified:

> Following Mrs. Thatcher's lead, the Administration is trying to suppress inflation by beating the entire economy into the ground. There is an old joke about a gypsy who eked out a meagre living by renting out the services of a horse he owned. One day, he decided to increase the profitability of this enterprise by training the old nag gradually step by step, to get by on smaller and smaller rations of oats. For a couple of weeks—I should say for a year now—the policy seemed to be succeeding very well until, to the poor chap's great suprise, the horse suddenly died.

Professor James Tobin testified:

> The money navigators are piloting the ship these days. After all the rhetoric of 1981, the Federal Government's only anti-inflation program is the same as Mrs. Thatcher's in England, the same old remedy that previous Administrations have intermittently tried. This is to depress monetary spending for goods and services and let competition of workers desperate for jobs and employers desperate for customers lower wage and price inflation rates. President Reagan and his three predecessors all swore not to use unemployment as a remedy for inflation. Every one of them has done so, and encountered the same difficulties.

Professor Lawrence Klein testified:

> The general economic environment (in early 1981) was extremely favorable and moving in a positive direction. What went wrong with the management of economic policy to throw the economy into a renewed recession after just one year, following the previous upper turning point? A combination of overreaction by monetary authorities in pursuing policies of tight credit, and serious miscalculation of accompanying fiscal policies by the Administration led to a compete breakdown of credibility vis-a-vis financial markets. The unusually high interest rates set back home buying, car purchasing, and other credit-based expenditures. In general, aggregate demand was weakened by a loss of confidence in national economic policy.

On the following day, January 20, 1982, the Committee heard from several respected economic analysts and forecasters.

Dr. Barry Bosworth testified:

> . . . the government, and particularly the Federal Reserve, had decided to adopt a hard-line policy of demand restraint as a primary means of fighting inflation. One consequence of this decision is that this recession is not an

> accident: it was the conscious and predicted result of policy decisions, and it should be analyzed as such.

Dr. Allen Sinai testified:

> The 1981 recession, I believe, came from a very tough and tight monetary policy . . .

Dr. Michael Evans testified:

> . . . I think the proximate cause of the recession was the tight monetary policy and high interest rates.

Finally, on January 26, 1982, the Committee heard testimony from Chairman Paul A. Volcker of the Federal Reserve Board. He had this exchange with Senator Sarbanes:

> Senator SARBANES. Chairman Volcker, would you agree that the high interest rates have contributed to the slowdown in the economy and the turndown in economic activity?
>
> Chairman VOLCKER. Yes, if you look at it in the narrow, immediate sense, yes.

Secretary Regan appeared before the Committee, as previously noted, on January 27, 1982. His testimony rewrote the economic history of 1981, and thus departed sharply from the Administration's past support of the Federal Reserve before this Committee. It did so by introducing a novel criticism, which had never previously been mentioned to us by any Administration official.

Secretary Regan acknowledged and repeated the Administration's general and often stated support for a gradual reduction of money growth:

> The President's original economic program included the recommendation that money growth be gradually reduced to a noninflationary pace. During the past year, the Federal Reserve made significant progress toward that goal.

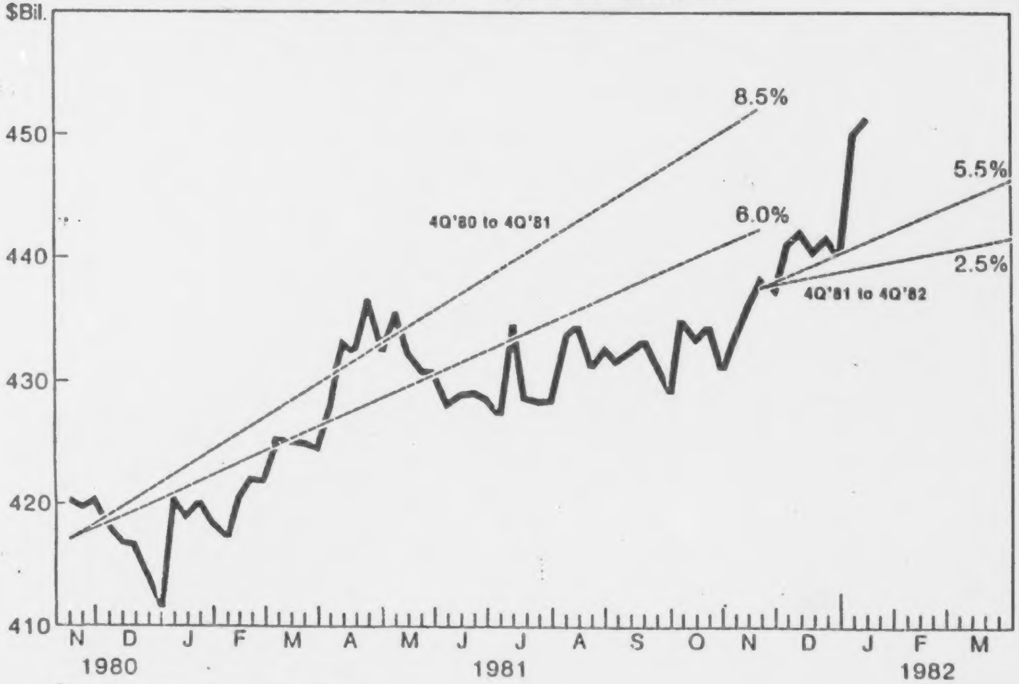
But the Secretary then misstated—more precisely, understated—the sharp reduction in money growth which had taken place with the Administration's support in 1981, relative to previous years.

> Fourth quarter to fourth quarter, M1B grew slightly less than 5 percent in 1981. Compared to the inflationary rates of monetary expansion in the past—7.3 percent in 1980 and an annual average of 8.0 percent in the preceding three years—this is a substantial deceleration in money growth.

The comparison of 5 percent 1981 nonshift-adjusted M1B growth with the 7.3 percent growth of 1980 is invalid, and suggests that the deceleration of M1B in 1981 was less severe than it in fact was. The proper comparison is between the shift-adjusted growth rate of M1B in 1981, which was 2.2 percent, and the 7.3 percent growth of the previous year. That 2.2 percent shift-adjusted figure can also be contrasted with the M1B target of 3.5 percent to 6.0 percent stipulated by the Federal Reserve at the beginning of 1981; the nonshift-adjusted figure of 5 percent must be viewed against a target range which is adjusted upward, to 6.0 to 8.5 percent, as a chart provided at the back of Secretary Regan's testimony, and reproduced here as Chart II-1, acknowledges.

CHART II-1

M_1 VERSUS TARGET RANGE*



*Weekly Averages - Seasonally Adjusted

+(Editor's Note: M1B, not shift-adjusted)

Source: Testimony of Secretary Donald T. Regan
Joint Economic Committee, January 27, 1982

The importance of Secretary Regan's misrepresentation of M1B growth as having been 5 percent in 1981 emerges in his testimony a few paragraphs later:

> . . . we supported money growth in the middle of the Federal Reserve's target range in 1981.

The intended logic is simple. If money growth was intended by the Federal Reserve to be 3.5 to 6.0 percent, and if the Administration had had a clear policy of supporting growth in the middle of that range, and if such growth was achieved, how can tight money as such be held responsible for the unexpected recession?

In fact, M1B growth, however measured, fell far below the bottom of the Federal Reserve's target range. And, as demonstrated above, the Administration had continued consistently to support Federal Reserve policy through the summer and fall even though that policy was leading to M1B growth well below the bottom of the target range.

Next, Secretary Regan launched an entirely new line of criticism against the Federal Reserve, drawn from a form of fringe monetarism whose ideas the Administration had never previously endorsed. The effect was to develop an entirely new explanation for the recession. Secretary Regan's comments are reproduced here:

> The erratic pattern of money growth that occurred in 1980 and 1981 and which contributed to the onset of the current downturn. At various times during the year, we at Treasury have hinted, sometimes in private, sometimes in public, that we would like either faster or slower money growth. Some have accused us of being unable to make up our minds.
>
> Nothing could be further from the truth. We have consistently urged faster money growth when the money supply was flat or declining, and slower money growth when the money supply was rising at double-digit rates. We supported the Federal Reserve's targets, and consistently urged them to keep money growth even and steady within the target range.
>
> In the last three months of 1980, M1B fell at an annual rate of 1 percent per year, after a sharp rise in the previous five months. Virtually all of the growth in M1B in 1981 occurred in the first four months of the year, when it grew at a 13.3 percent annual rate, and the last two months of the year, when M1B growth was at a 13.0 percent rate. In the interim, M1B oscillated from week to week. In the six months from April to October, the net change was a decrease of 0.1 percent. Such volatile money growth has very damaging effects on the economy. It destroys the credibility of long-run monetary controls, adds to uncertainty and risk, and thereby helps keep interest rates high as lenders seek to protect their principal.

This very erratic pattern has kept financial markets in a state of disarray for some time.

As a characterization of the Administration's position on monetary policy in 1981, the first two paragraphs of this quotation are misleading. The record of testimony before this Committee clearly indicates that the Administration had offered not one word of formal criticism of the variability of money growth until Secretary Regan's testimony. As late as October, both Chairman Weidenbaum and Director Stockman specifically defended the Federal Reserve against the charge that money growth was too low and the suggestion that it should be brought back within its target ranges.

As for the substantive charge leveled by Secretary Regan at the Federal Reserve, its disingenuous character is breathtaking. The Administration is now saying that week-to-week volatility of money growth, and not its low level, is responsible for the high level of interest rates. In so doing, they exonerate tight monetary policy, which they continue to support, and therefore themselves, from responsibility for the recession. And yet this new syllogism leaves the blame for the recession with the Federal Reserve!

The complete failure of any Administration official to criticize the Federal Reserve for short-run money growth volatility at any time in any of their numerous appearances to discuss monetary policy before this Committee in 1981 poses a problem for the line of criticism now being offered. The last such appearance, as noted above, was by Director Stockman on October 28, 1981. At that time, of course, every fact cited by Secretary Regan about the volatility of money growth from October 1980 through mid-October 1981 was already known, and yet no criticism was offered. One must, therefore, conclude that, with respect to monetary policies up to October 1981, the Administration changed theories after the fact. Such a change cannot, of course, lessen the Administration's responsibility for the consequences of a monetary policy which they supported at least until the end of October.

We believe the Administration cannot evade the simple facts of 1981, which are that tight money caused the recession, and that the Administration supported the tight money policy up and down the line.

Recommendation No. 10: Reject the Gold Standard

> **All forms of a return to the gold standard should be rejected by the President, the Administration, and the Congress.**

Discussion of monetary policy and of the Administration's economic policies was muddied in 1981 by a flurry of contrived interest in returning to some form of the gold standard. Certain supporters of the Administration's program, including some who had earlier been most confident of an immediate noninflationary economic boom, were heard to say, after high interest rates had negated their early optimism, that only a gold standard could lower inflationary expectations enough to permit the Economic Recovery Program to work. The United States Gold Commission, established in 1980 as part of a legislative compromise which permitted the most recent IMF quota extensions to go forward, was constituted in late summer and met throughout the fall and winter, with the statutory duty to evaluate and report on the present and future monetary role of gold.

The record of the Gold Commission confirmed the obvious: that supporters of a return to the gold standard have put forward no proposal which merits further attention. The supporters of such a return were revealed to be a heterogeneous group with differing historical conceptions of what the gold standards was, and with reform proposals ranging from free minting of gold coins to full convertibility of gold bullion to a slightly disguised money growth rule. In every case, these proposals were found to be deficient. Moreover, even if the obstacles of practicality could be overcome, there is simply no evidence that a return to any form of the gold standard would contribute in the slightest to the goals of high employment, rapid growth, or stable prices.

The gold standard's supporters have had their day in the limelight. The Administration and the Congress should dismiss any further efforts to keep this issue alive.

C. FISCAL POLICY

Recommendation No. 11: Promote Economic Recovery Now and a Return to a Balanced Budget

The tax cuts scheduled to go into effect on July 1, 1983, should be deferred, and reviewed in light of the economic situation and the state of the budget next year. Indexation of personal tax brackets to the Consumer Price Index should be repealed. This clear signal of responsible future tax behavior, with its resulting sharp diminution of the future deficit, will help to lower interest rates now, thus providing needed stimulus and promoting a rapid recovery from the present recession.

The deficits proposed by the Administration in the Fiscal Year 1983 budget are intolerable. Moreover, they are the direct consequence of the misguided tax, expenditure, and monetary policies which the Administration proposed in 1981. Only a reversal of these policies can restore the economy to a path of sustained, noninflationary growth, and the budget to a path leading toward budget balance.

The spending cuts proposed in the Administration's budget for Fiscal Year 1983 are harsh, deep, and severe. They would sharply reduce the levels of health care, nutrition assistance, and cash support for the poor and the elderly, as well as reduce the earned pensions of Federal and military retirees. But they do not begin to cope with the budget deficit. Even the severe reductions in entitlements which the Administration proposes would reduce the Fiscal Year 1984 deficit by only $17.1 billion—from a total estimated by the Congressional Budget Office to be $188 billion.

A change in the Administration's tax program is the only way deficits can be brought effectively under control. Such a change must accomplish two objectives: it must promote growth now and so expand the tax base, and it must provide for adequate revenues in future years, as the economy expands. The program which we present here, which provides for the deferral of the July 1, 1983, tax cut and for the repeal of indexing, meets both of these tests. And it is a simply and efficient immediate-action plan.

During 1981, the Reagan Administration, with the consent of Congress, put fiscal policy on a course which served only to accelerate the downturn brought about by its policy of tight money and high interest rates. In his February 1981 "Economic Recovery Program" proposals, President Reagan recommended a package of spending cuts that would have reduced fiscal 1982 outlays by $40 billion below 1981 current policy levels, combined with a three-year 30 percent personal income tax cut weighted toward those at the top of the income scale, the Kemp-Roth bill. Major business tax cuts were also recommended.

On July 29, 1981, Congress cut just over $35 billion from the fiscal 1982 budget, mostly in social programs. In September, the President, fearing a higher-than-projected fiscal 1982 deficit, recommended an additional $8 billion in social spending cuts, $4 billion of which were agreed to by Congress and the President in the continuing resolution passed on December 10, 1981.

In the meantime, on August 4, Congress enacted a somewhat scaled-down version of the Kemp-Roth tax bill—a 5 percent personal income tax cut effective October 1, 1981, followed by two additional 10 percent cuts on July 1, 1982, and July 1, 1983. The bill also adjusted tax brackets for inflation beginning in 1985, sharply reduced gift and estate taxes, and altered depreciation schedules and other provisions of the corporate tax code, effective January 1, 1981, in ways that will significantly reduce receipts from this source.

The combined effect of the Reagan Administration's tax and spending measures was to make fiscal policy restrictive in the short run. While the magnitude of the spending and tax cuts for fiscal 1982 are roughly equal and thus provide no net stimulus, the spending cuts are already being made, while the major portion of the tax cuts will occur only during the last quarter of the fiscal year. Moreover, the tax and spending cuts, combined, transfer disposable income from the bottom to the top of the income scale. Since upper income households save a much higher proportion of their incomes than do lower income households, this will increase the average personal saving rate and add to the restrictive effects of current fiscal policy. The increase in social security taxes which took place on January 1, 1982, will have the same effect. The tax base rose from $29,700 to $32,400 and the tax rate rose from 6.65 percent to 6.70 percent for both employers and employees. These measures combined raised social security taxes paid by up to 10 percent.

The Administration's tax and spending policies do not respond to the current needs of the economy. Since last summer, the economy has been in a steep recession. During the fourth quarter of 1981, real gross national product fell at an annual rate of 5.2 percent and our Nation's businesses operated at less than three-quarters of capacity. The unemployment rate has been rising sharply and reached 8.5 percent during January 1982 compared to 7.2 percent in July. As a result, more than 9.3 million Americans were jobless in January, almost as many as were unemployed during the Great Depression in 1939.

If the Reagan Administration continues to pursue its current tax and spending policies—and the Federal Reserve further tightens monetary policy—the effect will be to prolong and deepen the recession. We need a change in economic policy before more damage is done. Two steps are necessary.

First, the personal income tax cut that is currently scheduled to become effective on July 1, 1983, should be deferred, and reconsidered next year in light of budget and economic conditions then prevailing. This step alone would reduce the Fiscal Year 1984 deficit by almost $38 billion. The effect is to put the deficit on a sharply declining path as the recovery proceeds.

Second, monetary policy should respond to this act of fiscal responsibility by permitting interest rates to fall. This would have the effect of promoting recovery and expanding the tax base now, and so bring about higher employment, lower interest rates, and still lower deficits in the future.

This approach is in sharp contrast to current Administration policies, which will cause deficits to rise during the recovery period. According to the Congressional Budget Office, assuming no new tax measures, the Administration's program will cause a $ 109 billion deficit for 1982. This deficit is primarily due to the 1981-1982 recession. Under current policy, however, this deficit would be followed during the recovery by deficits that rise to $157 billion in fiscal 1983 and $188 billion in fiscal 1984. Deficits of this size during a recovery, combined with potentially large increases in borrowing by businesses and consumers, can only mean rising interest rates and renewed inflation—factors that contributed heavily to the current downturn.

Supporters of the Administration's lock-step tax reduction will argue that the phased-in three-year program should not be tampered with because it provides an incentive for saving and investment and because it reduces business uncertainty concerning future tax regimes. The evidence to date does not support this. We have seen no resurgence of business investment from this source.

In addition, the indexation provision of the Economic Recovery Tax Act of 1981, which requires that tax brackets be adjusted annually for inflation beginning in 1985, should be repealed. During periods of inflation, tax indexing will be especially damaging. Under indexing, the mandatory tax cut grows larger as inflation gets higher, thereby pumping up incomes and spending at just the time they should be held in check.

Recommendation No. 12: Review Tax Expenditures

Efforts to raise additional revenues in later years should begin with a comprehensive review of tax expenditures.

The massive budget deficits for Fiscal Years 1983 and 1984 resulting from the Administration's current economic policies can be reduced substantially by eliminating selected tax loopholes. A thorough review of all tax preferences should be part of any measure to raise revenues, but enactment should occur only after the recession has ended and the recovery is well under way.

For decades, Congress has made use of tax preferences and other forms of tax relief to channel resources into beneficial economic activities, such as business investment, homeownership, energy conservation, and support of charitable organizations. These should be continued. There are many other preferences in the tax code, however, which have channeled the Nation's resources into activities whose economic benefit is not justified by their cost, and which have disproportionately favored the well-to-do at the expense of the average taxpayer. By eliminating or modifying these tax loopholes, we would reduce the projected 1983 and 1984 deficits while at the same time improving the efficiency and equity of the economy.

The "tax-expenditure budget" which is published each year with the Budget of the United States Government lists the special tax preferences which result in a loss of Federal tax revenues. This budget, as drawn up for Fiscal Year 1983, consists of 96 items with a revenue loss of about $244 billion. By comparison, the tax expenditure budget for Fiscal Year 1977 consisted of 82 items with a total revenue loss of $106 billion.

For Fiscal Year 1983, the total revenue loss from tax preference items will amount to more than 32 percent of projected budget outlays. Despite the magnitude of the revenue loss, these tax preferences rarely come under close scrutiny or review. Many tax expenditures have outlived their usefulness, others are ineffectual in fulfilling their intended purposes or actually have a perverse effect on the economy, and many inequitably favor the well-to-do. All such provisions withhold revenue year in and year out from the U.S. Treasury. These are revenues which other taxpayers who are not so favored must make up.

Recommendation No. 13: Excise Taxes

> **We oppose regressive increases in Federal excise taxes solely to balance the budget. Such excise tax increases are inflationary and unfair in their incidence. Excise tax increases should be considered only where they serve a compelling public interest.**

Increases in Federal excise taxes, especially in the "sin taxes" on alcohol and tobacco, are a superficially attractive means of raising new Federal revenues. This temptation should be avoided.

Excise tax increases are inflationary in a direct and mechanical sense: they raise the price of the products to which they apply, and that increase enters directly into the Consumer Price Index. The result is to raise all wages and benefits tied directly to the CPI, so that the effect of an excise tax increase on the economy is magnified, among other things, increasing Federal expenditures and so partly offsetting the effect of the new revenue on the budget deficit. Higher inflation also affects inflationary expectations, and so puts upward pressure on long-term interest rates, which again offsets any positive effect of higher tax revenues on the credit markets. Thus, higher excise taxes are an inefficient macroeconomic and anti-inflation policy instrument.

Higher excise taxes are also unfair. They fall, first, on the particular industries to which they apply, which suffer lower sales and profits than otherwise. Second, they fall on those who continue to purchase the taxed goods, who suffer a loss of real income represented by the higher price paid. This loss of real income is regressive, since poorer people spend a higher fraction of their income on consumption than wealthy people do.

Recommendation No. 14: No Value-Added Tax

We oppose proposals to institute a national sales tax or value-added tax. Such a tax would fall disproportionately and unfairly on low- and middle-income people, thereby compounding the loss in real income they have suffered in recent years. In addition, introduction of a VAT would add to inflation in the short run.

A value-added tax (VAT) is a national sales tax levied on each sale that occurs in the production chain, not just on retail sales to final consumers. To avoid double taxation, businesses would be allowed to credit the VAT paid on their purchases against the VAT charged on their sales. By paying only the difference to the Federal Government, businesses in effect pay a tax only on the value they add during the production process. They full VAT would end up as part of the retail price, to be paid by the retail consumer.

Each 1 percentage point in the value-added tax would currently raise about $25 billion per year, if there were no exemptions, making VAT an attractive potential source of revenues in light of the massive budget deficits projected for Fiscal Years 1983 and 1984. In addition, the VAT is hidden in the price of goods and services and thus less offensive than a visible tax. Finally, since a VAT is levied only on consumption, households would be encouraged to consume less and save more.

Nonetheless, we oppose proposals to institute a national value-added tax. Since the tax is included in the retail price of affected goods and services, a VAT would be inflationary. Furthermore, a comprehensive VAT would be regressive, since lower-income households spend a larger fraction of their incomes on consumer goods, and save less, than upper-income households. Creating exemptions for particular kinds of goods and services that are considered necessities—such as food, clothing, and medical care—would make a VAT less regressive but far more complicated to administer. Finally, a VAT would create special problems for small businesses. With little market power, many small businesses would have to absorb the VAT out of profits in order to remain competitive while at the same time facing new reams of Federal paperwork.

Recommendation No. 15: Corporate Taxes

The Economic Recovery Tax Act of 1981 provided for accelerated depreciation as we had recommended in our last Report. However, there remains a danger that, as the rate of inflation falls, the new system will become distorted in favor of equipment and machinery and against long-lived structures at low rates of inflation. Should this happen, consideration should be given to measures such as open accounting, which would restore neutrality of the depreciation schedules with respect to types of investment, and eliminate any danger of negative effective tax rates. Provisions providing for tax leasing should be repealed or sharply overhauled to repair abuses, thus saving up to $5 billion per year.

In our last Annual Report, we recommended that the depreciation provisions of the corporate income tax be revised in order to encourage investment and make the tax laws neutral in their effect on the composition of the capital stock during periods of inflation. The Adminstration's Economic Recovery Tax Act of 1981 provided for accelerated depreciation, as we recommended, in the form of the so-called modified 10-5-3 Accelerated Cost Recovery System (ACRS). While ACRS should stimulate business investment as it is phased in through 1986, it is neutral among classes of capital goods only within a narrow range of inflation and thus requires further revision.

Under the Accelerated Cost Recovery System, the more than 100 asset classes that existed under prior law are combined into just three classes for depreciation purposes, with most short-lived property depreciated over a three-year period, most equipment over a five-year period, and some utility property over a 10- or 15-year period. Structures are to be depreciated over a 15-year period.

Since ACRS greatly reduces the time period over which a corporation depreciates its assets and thereby increases the after-tax rate of return, ACRS should provide a stimulus for more business investment in both equipment and structures.

Unfortunately, ACRS did not solve the neutrality problem. Under prior law, the capital depreciation provisions resulted in some asset classes being effectively taxed at lower rates than others. As a result, the composition of business investment differed from the composition that would have occurred under a neutral tax system. This reduced the overall productivity of our capital stock and held down our economy's growth.

While ACRS reduces the tax rate on all asset classes, neutrality problems remain, particularly as inflation wanes. For example, one CRS study found that at a 6 percent annual inflation rate, ACRS results in a negative effective tax rate (i.e., provides a subsidy) for such short-lived assets as cars, trucks. construction equipment, general industrial equipment, and industrial steam equipment, and a positive tax rate on such long-lived equipment as utility powerplants, industrial and commercial buildings, and apartment buildings.

We continue to be concerned about the neutrality of the corporate income tax. Among the possible revisions to the ACRS which Congress should examine is open accounting. Under open accounting, long used in Canada, businesses each year write off a portion of the total value of assets in each asset class according to a fixed schedule, rather than depreciate each asset individually. Alternatively, business assets could be valued at current rather than historical cost for depreciation purposes, or business could be permitted to expense the present value of the depreciation allowances for each asset as proposed by Professors Dale Jorgenson and Alan Auerbach. Any of these proposals would restore neutrality of the depreciation schedules with respect to types of investment and eliminate any danger of negative effective tax rates.

The new provision in the corporate tax code which permits unprofitable firms to lease their unusable tax credits and depreciation deductions to firms with taxable profits should immediately be repealed or overhauled to repair abuses. During the next six years, this provision will cost the Treasury $29.1 billion by official estimates and much more according to other observers, while effectively eliminating the corporate income tax for many highly profitable firms.

If the goal of this tax-leasing provision were to eliminate the corporate income tax or to subsidize firms experiencing losses, the same objectives could be accomplished in more equitable and less costly ways. For example, the corporate income tax could have been eliminated altogether and corporate earnings integrated into the income of stockholders for income tax purposes, as many economists have recommended. This would eliminate double taxation of business earnings while still assuring a fair taxation of corporate profits. Alternatively, to help firms with losses, investment tax credits could have been made refundable. Unprofitable firms would be able to use their investment tax credits and depreciation deductions while profitable firms would still pay their fair share of taxes. Either path would be preferable to the back door tax giveaway of the tax leasing provision.

Recommendation No. 16: Spending

> **Further consideration of deep reductions in spending for social programs should be deferred until recovery from the current recession is well underway, except that the Administration and Congress should continue aggressive efforts to eliminate waste and mismanagement. The projected increase in defense expenditures are too large and should be scaled back.**

We oppose the President's recently announced proposal to cut an additional $41 billion from the fiscal 1983 budget. Federal spending should be held in check wherever possible, and the budget of each program should be vigilantly scrutinized to provide taxpayers the best government services their hard-earned money can buy. In fact, despite the budget-cutting fervor of this Administration, we believe there are still large parts of the Federal budget that have escaped serious review, particularly the defense budget and the tax expenditure budget.

But a recession is not the time to cut billions of dollars from vital social programs. Cuts of the size proposed by the President for fiscal 1983 when piled on the almost $40 billion already cut from the fiscal 1982 budget will only prolong the recession. Further massive spending cuts now will hamper the ability of the economy to rebound from the downturn and may even set the stage for a further decline when the cuts take effect later this year.

During the period since World War II, our economy has weathered seven recessions without a depression largely because of the floor provided by both discretionary and automatic countercyclical spending programs. During the 1974–1975 recession, for example, the loss of income for two-thirds of the 7.9 million who were unemployed was cushioned by up to 65 weeks of unemployment insurance. In addition, Congress swiftly enacted programs designed to create jobs for those laid off, including 700,000 public service jobs under Title VI of CETA, a short-term public works program, a countercyclical revenue sharing program, and measures to stimulate housing construction.

The spending cut proposals made by the President for fiscal 1983 will have just the opposite effect. Instead of expanding the safety net to help the increasing number of jobless workers, the Reagan Administration's program will leave the unemployed with inadequate assistance. As George Perry testified before the Committee on October 21, 1981:

> The longer run deficits represent poor economic policy. But some ways of attempting to cut those deficits would be so undesirable on other grounds that the status quo should be preferred. It would be poor economic policy and unconscionable social policy to place the burden of further budget tightening on the less priviledged, on State and local governments, on public investment, on education and research, and on important general government activities such as data gathering and dissemination. We are the world's greatest and richest economy. We should not behave like mean-spirited paupers towards government activities and responsbilities that are an accepted and important part of a modern society.

A deep recession is no time to make massive cuts in vital social programs. Consideration of further spending cuts should be postponed until the economy is well on the way toward full recovery.

D. FAIRNESS

Recommendation No. 17: Fairness

> **The Reagan Administration has turned its back on the principles of fairness and opportunity for all which for 50 years have underpinned our society. This Administration is leading America toward greater unfairness by all its policies—tax, expenditures, monetary, regulatory. Ever-greater inequities diminish the traditional American value of economic opportunity, reduce the prospects for sustained economic growth in which all share, and threaten national unity. We urge that Congress defend the principles of fairness and equal economic opportunity in its tax, spending, and regulatory decisions.**

In taxation, the Administration's income tax reductions benefit chiefly the top bracket of income receivers. Furthermore, the steep reductions in taxes on "unearned" income, from securities and from capital gains, have far outstripped the reduction in the taxes on wages and salaries of those who work for a living. The corporate income tax is for all practical purposes being phased out, except for continued unavoidable taxes on small business corporations. And the check on huge intergenerational accumulations of wealth once provided by our system of estate and gift taxation has been largely done away with.

In its spending reductions, the Adminstration has sharply disadvantaged the working people and the middle class generally through cuts in programs which affect the basic quality of life: education, nutrition, health, clean air and water, the arts and humanities, and transportation. Only the very affluent have been spared the expenditure axe, through the continuation of subsidies such as those to yachtsmen, to travelers abroad, and to pleasure aircraft owners.

In its monetary policy, the Administration by super-high interest rates has shifted billions of dollars in income and wealth from debtors to creditors.

In its regulatory policy, the Administration has reduced the basic protections of life and limb in the workplace, in the marketplace, and in the environment around us. Cutbacks in mine safety inspections pose an especially dangerous threat to our Nation's coal miners.

Elsewhere in this Report, we have detailed the unfair consequences of the Administration's spending cuts, of its Kemp-Roth income tax rate reductions, and of its regulatory policies. Other especially unfair aspects of the Administration's program include the redistributive effects of high interest rates and new tax benefits for the extremely wealthy.

Skyrocketing interest rates led to an increase in personal interest income in excess of 20 percent in 1981, to more than $300 billion. Interest accounted for nearly 13 percent of total personal income, a record high; this represented an acceleration of recent trends: interest was less than 10 percent of income in 1977 and only 5 percent in 1956.

The distribution of interest income is highly skewed toward the upper income brackets. In 1979, the top 24 percent of taxpayers received 50 percent of taxable interest; the top 3 percent received 21 percent; and the top 1 percent received 13 percent. And these figures seriously understate inequality in the distribution of total interest income, for they exclude tax free interest paid by State and local governments, concentrated almost exclusively in the very highest income brackets.

The Reagan program, which is pushing interest rates even higher, can only exacerbate these trends. The reduction in the top marginal rate on "unearned income," which includes interest income, from 70 percent to 50 percent, effective January 1, 1982, nearly doubles the portion of taxable interest retained by those in the top bracket, from 30 percent to 50 percent. And, with the financial burdens being placed on State and local governments, the volume of tax-exempt All-Savers certificates, and the liberalization of IRA's, State and local bonds lose some of their competitive advantage in credit markets, so they will have to pay even higher interest rates to attract affluent bond purchasers.

President Reagan's Economic Recovery Tax Act of 1981 reduced the maximum tax rate on long-term capital gains from 28 percent to 20 percent on sales or exchanges after June 9, 1981. This is lower than the marginal tax rate (21 percent) paid on a joint return with taxable income of $12,000 last year. Capital gains income is highly concentrated in the upper income brackets. In 1979, 57 percent of capital gains were received by the top 3.3 percent of taxpayers, 47 percent by the top 1.2 percent, and 28 percent by the top 0.1 percent (those with adjusted gross income over $200,000). It is doubtful if there has ever been a tax provision based less on economic need.

Savings rose temporarily to 6.3 percent of personal disposable income in October, when the tax cut took effect, but fell back to 5.5 percent by December. The December savings rate was below the 1980 rate and below the average for the last five years.

Similarly, last year's Tax Act lowered the top rate on dividends from 70 percent to 50 percent, effective January 1, 1982. Dividend income is similarly concentrated among the affluent. In 1979, 71 percent of dividends were received by the top 15 percent of taxpayers; 42 percent by the top 1.2 percent; and 21 percent by the top 0.1 percent. Table II–12 shows how interest, dividend, and capital gains income is concentrated in the hands of the well-to-do.

TABLE II–12.—PERCENTAGE OF TAX RETURNS, TAXABLE INTEREST RECEIVED, CAPITAL GAINS, AND DIVIDEND INCOME, BY ADJUSTED GROSS INCOME LEVEL, 1979

[In percent]

Adjusted gross income in excess of	Tax returns	Interest received	Dividends received	Capital gains received
$1,000,000	0.0	0.7	5.2	12.4
$500,000	0.0	1.5	9.7	18.1
$200,000	0.1	3.9	20.8	28.4
$100,000	0.6	8.8	34.6	40.2
$75,000	1.2	12.7	41.7	46.6
$50,000	3.3	21.4	53.9	57.4
$40,000	6.3	28.7	60.9	64.9
$30,000	15.3	41.2	71.3	74.4
$25,000	24.2	50.0	76.9	80.4

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income, "SOI Bulletin," Summer 1981, p. 8.

Last year, estate and gift taxes were also slashed in the Administration's tax bill. The cumulative exemption from the estate and gift tax will rise in steps, from $175,625 in 1981 to $600,000 in 1987 and subsequent years. And the top rate is being reduced, from 70 percent on taxable transfers over $5 million to 50 percent by 1985. The Joint Committee on Taxation estimates that these changes will reduce estate and gift taxes by more than $22 billion for 1981 through 1986. By Fiscal Year 1985, the tax yield will be reduced by more than 40 percent.

President Reagan seems to have completely reversed the principles of President Franklin Delano Roosevelt. In 1933, F.D.R. stated:

> The test of our progress is not whether we add more to the the abundance of those who have enough. It is whether we provide enough for those who have too little.[1]

The implications of these unfair policies are clear: sharp increases in the inequality of the distribution of income and wealth.

E. STRUCTURAL REFORM

Recommendation No. 18: Basic Industries

We must address the problems of those basic industries, including steel, automobiles, and aircraft, which form the backbone of America's industrial structure. Future poli-

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[1] As quoted in the Congressional Record, January 28, 1982, p. H89.

cies must stress modernization, reorganization, and adjustment, and must include strong and clear performance criteria. Polices to promote the adjustment of firms should be coordinated with policies promoting the adjustment of workers and communities.

Every country, including the United States, has, at the least, an implicit industrial development policy, in the sense that the combination of monetary, tax, spending, and regulatory policies it adopts helps to determine the type of industry that will flourish within its frontiers. An advantage of those systems whose industrial development policy is explicit is that the goals of policy are stated, and progress toward their attainment can be monitored. Such systems possess a means of evaluating the effect of government policy on industry, and we do not.

An overall assessment of the effect of U.S. Government policy on our basic industries is difficult, in part because many policies overlap with or partly contradict each other. The pattern which is suggested by our trade policies does suggest, however, that the net effect is not neutral. The pattern of U.S. trade and trade-related policy has been, on balance, to favor older, import-competing sectors such as steel, automobiles, and textiles. This pattern, in economic terms, represents an investment of resources which comes at the expense of other possible activities, including the active promotion of export-competitive industries, particularly at the high end of the technological scale.

In the area of textiles, import relief has taken on a permanent character and been extended from intermediate products to include finished goods. For the last 20 years, textile and apparel imports have been governed by some kind of international framework, the most recent being the revised Multifiber Agreement just concluded at Geneva. Once the decision was made to protect textiles, the inclusion of apparel followed inevitably, since without the added protection, U.S. apparel makers buying domestic textiles would have been placed at a competitive disadvantage.

Over the long term, the Multifiber Agreement has not kept the domestic textile industry from re-emerging as a competitive producer. The structure of the industry encouraged the rapid diffusion of technological innovations and new equipment. As a result, portions of the United States textile industry have become major competitors in world markets. But technological change has not come as rapidly to the apparel field and much of U.S. industry would be unable to survive without trade protection.

For more than a decade, the government has been giving intermittent trade protection to portions of the domestic steel industry, which has failed to keep pace with the modernization and increasing efficiency of foreign steel producers. The steel industry has argued that foreign competitors have been selling steel in the United States below the costs of production in foreign countries—a violation of the 1974 version of the U.S. Anti-Dumping Law. Under considerable pressure from the steel industry, the Carter Administration agreed to initiate an anti-dumping investigation if any steel entered the United States below the cost of production in Japan—the "trigger price mechanism" (TPM). There remain disputes about how effective the TPM has been in stopping the European countries from dumping in the American market. American steel users also allege that foreign producers are guilty of downstream dumping—selling steel at below-market prices to enhance the competitiveness of foreign steel users. There is some danger that American steel users will point to the logic of the Multifiber Agreement and press for comprehensive protection for the steel industry and for themselves.

In isolated cases, the government has come to the rescue of large individual companies with direct loan guarantees—the major examples in recent times being Lockheed and Chrysler. In both cases, the loan guarantees forestalled possible bankruptcy. Lockheed paid back its guaranteed loans, but could not achieve sufficient sales of its Tri-Star jetliner to make a profit on it, and last year announced termination of the program. While the jury is still out on the Chrysler Corporation, it is no secret that the company is experiencing great difficulty, partly as a result of the recession, and that it has not met the performance criteria specified in early, optimistic plans.

In the wake of the Chrysler bail-out, there have been a number of steps designed to help the beleaguered U.S. auto industry, among other basic industries. In April 1981, the Reagan Administration sought and received "voluntary" limits on exports of Japanese automobiles to this country. In August 1981, the President signed his tax bill, which included leasing provisions which are especially beneficial to the auto industry.

The present Administration has not expressed much interest in the ongoing debate over an American industrial policy; nor has it formulated policy with an explicit orientation to the needs of basic industry. The result is that policy affecting these sectors continues to be made on an *ad hoc* basis. It is therefore likely that we will continue to provide subsidies as demanded to our basic industries with one hand, while at the same time the other hand creates, through high interest rates, recession, and an overvalued dollar, conditions that contribute to their distress.

Our implicit industrial policy is also deficient in the failure to coordinate programs which facilitate adjustment by workers and by communities with programs directed at adjustment by firms. Thus, we have the spectacle of a major steel company taking advantage of trade protection and new tax provisions to acquire the resources with which to acquire an oil company, while plant closings leave tens of thousands of steel workers unemployed, and steel communities like Youngstown, Ohio, struggling for survival. As Professor Robert B. Reich has put it in a recent paper:

> While firms often are capable of divesting themselves of their least competitive parts and diversifying in more promising directions, a large part of the labor force is relatively immobile both in terms of geography and skills. Workers are often unwilling to leave family, friends, and familiar territory; unable to finance their own retraining; and ignorant about where new jobs are located and for what jobs retraining should be sought. By the same token, the community's infrastructure of roads, educational insti-

tutions, and other public goods often depends on a steady stream of tax revenue; the sudden departure of industry thus may leave the community without any alternative means of support—and just at a time when demands on public services by the newly unemployed are at their peak. The management of industrial decline thus requires not only that resources be moved to more productive and competitive uses, but also that the movement be coordinated so that all resources can be fully utilized.[2]

This Committee believes that a more sensible approach is possible. A better macroeconomic climate would, of course, greatly improve the prospects for those companies—automobile firms are an example—some of whom are spending billions to transform themselves into producers of competitive products. For those basic industries which will continue, from time to time, to get into trouble, assistance, if it is to be delivered at all, must be accompanied by a plan for adjustment, adaptation, modernization, and return to competitive viability. And the Executive Branch, if it is to be asked to supervise such a program, should be equipped with sufficient technical expertise to ensure that the conditions laid down by Congress can be enforced. Congress, moreover, should retain an independent capability in the General Accounting Office (GAO) to audit any future loan guarantee operations, by keeping the Comptroller General off of future loan guarantee boards.

Finally, a sensible policy toward basic industries would coordinate programs directed at companies, communities, and workers, and so endure that workers and communities share in the benefits of Federal policies designed to help our basic industries once again become competitive in world markets.

Recommendation No. 19: Promote Catalysts[3][4]

> **An American approach to industrial development should emphasize industries which can act as CATALYSTS to economic development and job creation. A catalytic industry may be defined in any of several ways:**
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> **As one with extensive backward and forward linkages in the economy, so that strong advantage in that industry leads to strong advantages in a wide array of final products. The steel industry played this role in past decades for a wide range of fabricated projects. Today, the semiconductor industry is the catalytic center of industries as varied as computers, robots, telecommunications, and a host of electronic products.**
>
> **As one in which the United States has a valuable and underexploited resource advantage, such as coal.**

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[2] Reich, Robert B., "Making Industrial Policy," unpublished paper.

[3] Representative Hamilton states: In respect to recommendations Nos. 19 and 26, while both incomes and industrial policies need to be explored, and I commend the Joint Economic Committee for that effort, I am unable to endorse fully these recommendations without more detail.

[4] Representative Long states his reservations regarding the part of this recommendation on high-speed rail are included in the supplemental views to the Committee's earlier report on the subject.

As one in which, due to past imbalanced patterns of development, unique opportunities exist, such as regional high-speed passenger rail.

The role of government in promoting catalysts should vary according to the situation, but in all cases the objective is the same: to foster public-private cooperation and a climate in which economic development can take place.

We believe that the dichotomy in discussions of policy toward industry between advocates of "picking winners" and advocates of "saving losers" has led the argument down an intellectual dry well. The first alternative is impractical, the second, foolish. To some, that appeared to close the matter.

We disagree. There is a role for government policy in the pursuits of sensible industrial development goals. We have not come up with a single grand criterion which encompasses all of the right things to do and rejects all of the wrong ones. But we have agreed on a general approach which is consonant with our traditions, resources, and opportunities, and which respects and strengthens the role of private enterprise and competitive markets in our economy. We call our approach "promoting catalysts."

In chemistry, a catalyst is a chemical which facilitates a reaction, thereby increasing the efficiency which resources, like heat, can be applied to a process, and sometimes making possible transformations that weren't possible before. Similarly, government policy should seek for areas of enterprise where a little public-private cooperation, a little access to credit, or a little infrastructure development can have far-reaching effects on the efficiency of our resource use, our future pattern of development and growth, and the competitiveness of our final goods industries. The examples are many. Three, which illustrate different but representative cases which the Committee has examined in hearings or staff studies in the past 14 months, are semiconductors, coal, and regional high-speed passenger rail.

Semiconductors

The American semiconductor industry provides an example of a catalyst industry, because of its extensive linkages forward into mainframe computers and electronically controlled equipment of all types, and backward into high-quality technical education, and because the success of the industry depends on rapid market penetration and volume sales, which may be facilitated or impeded by government policy.

The objective of U.S. policy toward the semiconductor industry should be to maintain a climate in which an already highly successful industry can continue to flourish, and to guard against policies by other governments which might unfairly advantage their competing semiconductor sections to the detriment of ours.

The current strength of the United States' semiconductor industry is the product of a variety of forces, some of which have emerged because of government policy, and others in spite of it. The high quality of technical education in the United States, much of it fostered by government in the aftermath of Sputnik, no doubt fertilized the ground for rapid technological advance in microelectronics. Defense Department and NASA spending on research and development helped refine the semiconductor, and provided a large market which helped put the industry on its feet.

Other aspects of government policy have been less propitious. The recession of 1974–75, in part brought about by tight monetary and fiscal policies, stunted investment in certain mass-market chips, allowing the Japanese to gain a significant volume and cost advantage. Currently, some observers argue that the highly specialized semiconductor needs of the Defense Department are diverting resources away from the development of the most promising commercial technologies and thus weakening the future competive position of the U.S. semiconductor manufacturers. Others charge that the government is not doing all it can to assure market access in foreign countries for U.S. semiconductor firms, thus denying them the sales volume needed to achieve a competitive cost position.

The dynamic firms in Silicon Valley are now feeling the pressure of foreign competition and high capital costs. The problem has been particularly acute with Japan, whose industry appears to have three distinct advantages. First, the Japanese market remains closed in significant respects to U.S. exports. Japan can thus compete for the world market, while the United States is excluded from Japan, the world's second largest consumer of semiconductors, and so Japanese manufacturers can maintain a significant cost and volume advantage in certain mass-market chips. Second, high technology industries in Japan are specifically targeted by the Japanese government, and so have assured access to finance capital and other assistance. Third, lower Japanese capital costs also contribute to a potential cost advantage for the Japanese semiconductor manufacturer. The lower Japanese interest rates are in part a function of Japan's more balanced macroeconomic policy, but they also reflect the relative isolation of Japan's financial markets.

The Japanese are improving their worldwide share of semiconductor sales. They have captured a large share of the American market for the advanced 64K RAM. Many observers think the Japanese are already ahead in the race for the next leap in semiconductor technology.

In this environment, it is vital that the U.S. Government develop and maintain close links with our merchant semiconductor producers, and that it become fully equipped to monitor developments in world semiconductor markets, especially Japan. Support for technical education necessary to foster the next generation of electronic engineers should be maintained and strengthened. The impact of Defense Department research requirements on commercial semiconductor research and development should be evaluated, and recommendations made to ensure that we do not needlessly sacrifice the competitiveness of this industry.

Semiconductors are a catalyst industry which we now have, and which we must preserve for the present and the future.

Coal

The need to increase U.S. production of coal is a case of a challenge that can be transformed into an opportunity.

The World Coal Study [5] has projected that domestic production of coal will have to double by 1990 and triple by the year 2000 over its production rate of 1978 if energy supplies are to be available sufficient to accommodate expected economic growth. While U.S. coal output has expanded an average of 5 to 6 percent a year for the last decade, a remarkable change from decades earlier when coal usage and output declined regularly year to year, such a rate is not nearly enough to meet projected national needs.

Because coal is a relatively inexpensive energy source, the demand for it will inevitably increase. If the cost of obtaining a given amount of energy from coal were the same as the current price of obtaining the same energy from oil, the cost for a ton of standard coal would be $165. In fact, coal, if delivered to user or port, sells today for only $20 or $40 a ton. Indeed, much of that price is accounted for merely by the cost of delivery; coal at certain Wyoming mines, for example, sells as low as $7 a ton at the minehead. Even adding costs which have been calculated for compliance with environmental standards, and an imputed cost for the inconvenience of coal compared to oil, the price of coal would still be much lower than that for oil.

If energy supplies are to expand, it is not nuclear energy or oil, but coal, which represents the most available and reasonably priced new source. Unfortunately, several factors have acted to constrain both demand and output.

There is, first of all, the question of how to finance the conversion of power stations. The expense of converting oil stations back to coal is, in some cases, greater than the expense of building new coal-fired plants from scratch.

There is also uncertainty which exists in the United States and elsewhere as to the rate of growth of electric power. For the 20 years prior to 1974, electric output grew at a rate of 7 to 8 percent a year, but following the first round of OPEC price increases, the power industry began to experience a holding pattern, with electric output expanding at an average rate of only about 3.5 percent a year. In many respects, the power industry at the present time has excess capacity, and yet long lead times are required for the development of coal-fired power plants.

Increased production of coal should be encouraged as a matter of national policy. Expansion of coal usage and coal production will reduce American dependence of overseas sources of oil. But coal also holds extraordinary potential for the expansion of support industries and the creation of jobs. Production of such items as large shovels, heavy carriers, and new underground mining machinery will be required for expanded mining operations. In addition, new and converted boilers, processes for fluidized bed combustion, and equipment for scrubbing, particulate control, and ash disposal will be needed.

Increased coal production will also require an expansion of transportation facilities. Barge transport on the Mississippi and Ohio Rivers, for example, would have to be modernized. The establishment of slurry pipelines would be another prospective development. We stand today at the threshold of large-scale use of these pipelines. The main obstacle seems to be the need to acquire the right-of-way for the ground on which they would be laid; another problem is importing the water in which the crushed coal would be fed down the pipeline from the coal-producing States. Both these problems can be solved, however, by the application of a clear congressional will. New deep-sea ports will have to be dredged and prepared. Normal sized coal carriers weigh 50,000 tons when loaded, but few American ports can handle them at present. None can handle the 100,000 ton coal carriers now coming into increasing use.

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[5] The World Coal Study was an international project involving over 80 experts from 16 major coal-using and coal-producing countries. It was directed by Prof. Carroll Wilson, of the Massachusetts Institute of Technology, and its report was issued in 1980.

Only 100 million tons of coal are traded today; the World Coal Study projects that this figure might increase to 400 million tons in a few decades. The United States could, by the year 2000, earn $12 to $17 billion in 1978 dollars from coal. In contrast, the United States earned $16 billion for grain and soybean trade in 1978.

A program of increased coal production must be accompanied by the establishment, and strict enforcement, of rigorous environment standards. The social and environmental hazards of "boomtown" development can be avoided by careful foresight and planning. The technology already exists to deal effectively with certain other pollution problems, such as acid rain (by means of fluidized bed combustion, improved scrubbing of coal gases, etc.), but the application of this technology remains in many instances to be mandated. Other issues, such as the possibility of a "greenhouse effect" associated with excessive emissions of carbon dioxide into the atmosphere, must be thoroughly researched and rigorously monitored.

High-Speed Regional Rail Passenger Service

The National Transportation Study Commission reported in June 1979 that a "transportation crisis in this country is just around the corner." The Commission estimated that, by the year 2000, national domestic person-miles of travel will increase between 81 and 96 percent and national domestic freight ton miles will increase between 165 and 314 percent. It concluded that the present transportation system will be hard-pressed to handle such dramatic increases.

The U.S highway system is rapidly deteriorating. The Federal Highway Administration projects that an expenditure of $360 billion over the next 15 years would be required merely to maintain and repair existing far-from-adequate road quality. The Nation's major airports and primary airlanes are also seriously congested. Many smaller communities are losing service as a result of the increasing costs, especially fuel costs, of providing service.

The Nation's railway system is at the present time in no position to pick up the slack. Track and equipment are deteriorating. The increase in the price of petroleum-based fuel has made railroad travel, as air travel, increasingly expensive.

Advanced industrial nations abroad have remained dedicated to the provision of high quality rail service. Japan inaugurated "bullet train" service almost 25 years ago. Trains between Tokyo and Shin Osaka average 100 miles per hour and attain top speeds of 130 miles per hour. One hundred twenty million passengers a year use these trains. They operate reliably and the technologies on which they are based are being continually redesigned and improved. They also operate without government subsidies and even make a profit. In September 1981, the "Tres Grande Vitesse" made its debut as the French entry among bullet trains. It travels between Paris and Lyons, attaining top speeds approaching 160 miles per hour. Throughout Europe and Canada, high speed trains are either already in operation or currently being developed.

American trains pale in comparison. The average speed of a passenger train in this country has declined from 75 miles per hour in the mid-1950's to a current average of 40 miles per hour. Amtrak today operates only 1,700 passenger cars. Despite smaller populations, the majority of the European nations operate at least five times as many passenger cars. Japan operates 26,000 cars over a rail system that covers only half the mileage of the U.S. system, in a country which is the size of the State of Montana.

The reason for the decline experienced by America's rail transportation system is not only the comparative appeal of air and automobile travel, but certain changes undertaken in rail operations over the past 30 years that have ultimately proved deterimental. Freight railroads, in response to market conditions and cost considerations, have relied increasingly on longer, heavier, and slower trains. This has hurt passenger service because it has caused greater stress and damage to railroad tracks and road beds, and it has necessitated adjustments in grade crossing signaling systems, and the super elevation of track, both of which impede high speed rail travel.

To the extent that trains are convenient, reliable, and fast, the demand for their service has remained high. Regrettably, these conditions are obtained only rarely in the American rail passenger system.

The Committee, in a bipartisan, consensus report entitled "Case Studies in Private/Public Cooperation to Revitalize America: I. Passenger Rail," has proposed developing such service in 20 highly populated rail corridors. Other recommendations included the separation of passenger and freight systems (to eliminate the problems associated with the different track, signal, and operating requirements of these operations); the use of advanced technology as applied in the development of both the French and Japanese rail systems; the electrification of rail lines to improve the energy efficiency of service; the elimination of grade crossings to enhance train speeds; and the cooperation of business, labor, and government in bringing a project of this magnitude and importance to fruition.

Amtrak President Alan Boyd testified before this Committee on July 23, 1981, that high speed rail passenger service can be made profitable in this country. Moreover, he indicated that such service could prove an attractive enough business proposition to spur private investment, and eliminate any need for direct Federal operating subsidies for high speed service. In light of the substantial initial risk that would be undertaken by private business in such a venture, however, government loan guarantees have been suggested as a means of indirect and limited, but very helpful, government assistance. Were it to become a matter of national policy that such a system be developed, this Committee would also propose the establishment of a Rail Corridor Development Expediter, a coordinator of activities centrally located in the White House whose purpose it would be to ensure that the proper importance remained attached to the implementation of national rail policy.

The Committee believes that such an undertaking would produce not only major direct economic benefits, but indirect ones as well, such as providing an infusion of capital into depressed industries and encouraging technology transfers throughout the economy. Now that much of the Nation's highway construction is complete, the highway construction industry's talents and capabilities could be readily channeled to such purposes as grading, building bridges, pouring concrete, and building fences and stations for a new rail transportation system. Moreover, a whole new industry of rail cars, locomotives, and equipment can help reemploy our skilled manufacturing labor force and the excess capacity of our metal-working industries.

In the same way that the development of an automobile industry in the 1920's not only changed the face of America's transportation system, but also created untold new jobs and business, the development of a new high speed rail passenger service-oriented industry could serve as the catalyst to renewed economic prosperity that the United States is so lacking today. The Committee is proud of the bipartisan consensus with which these recommendations have been made, and believes this bodes well for the pursuit of such a policy.

Recommendation No. 20: Maintain Infrastructure

> **Investment in infrastructure—roads, bridges, water systems, ports, rails, utilities, and other physical support systems—must be restored to adequate levels. The ability of State and local governments to meet their responsibilities in this area has been sharply impaired by recent budget cuts. The urgent and overlooked task of restoring our infrastructure should take priority over certain other engineering and development expenditures which the Administration continues to support. Soil erosion is a serious problem and should be treated as an urgent item of rural infrastructure maintenance.**
>
> **We propose:**
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> **That remaining funds in the budget for interstate highway construction in urban areas be redirected to maintenance of this system.**
>
> **That Department of Energy funds be reallocated from exotic and uneconomic projects in the nuclear field, including the fast breeder reactor, and spent instead on energy conservation and accelerated conversion of electric power generation to coal.**
>
> **That certain unnecessary projects of the Corps of Engineers and Bureau of Reclamation be canceled and the resources invested instead into upgrading ports and other high priority projects.**
>
> **That the Department of Agriculture continue on an urgent basis a national evaluation of the problem of soil**

erosion, and programs to combat this danger, including measures to promote conservation tillage.

Perhaps the most neglected item in redeveloping the Nation's industrial base is the need to maintain and restore its capital facilities. In large part, our network of highways and bridges, ports and railroads, and adequate water and utility systems are responsible for the Nation's productive capacity. In recent years, however, real capital expenditures at all levels of government have declined. Combined public works investments by Federal, State, and local governments in constant 1972 dollars peaked in 1968 at $41.1 billion ($4.7 billion Federal, $15.2 billion State, and $21.2 billion local) and declined to $29.4 billion in 1977 ($4.3 billion Federal, $9.3 billion State, and $15.8 billion local). As a share of State and local government budgets, the decline is even greater. As George Peterson of the Urban Institute noted in his testimony before the Committee on January 27, 1981:

> . . . one of the most constant economic features of our time since the mid-1960's has been the year-in, year-out decline in the share of State and local budgets that are used for capital purposes—either capital purposes or maintenance purposes. The capital share alone is down from about 28 percent in the mid-1960's to 15 percent of State and local budgets in the last three years (1977-1979). Spending for capital, spending for maintenance, has gradually been displaced by spending for social programs.

These declines in capital funding have resulted in a deterioration of the basic public facilities upon which our economy relies. Over 8,000 of the 42,500 miles of interstate highways and 13 percent of its bridges have now exceeded their designed service life and must be rebuilt; the costs of rehabilitating and constructing our nonurban highways necessary to maintain existing service levels will exceed $700 billion in the 1980's; the 756 urban areas with populations over 50,000 will have to spend between $75 to $110 billion just to maintain their water systems and it will cost upwards of $33 billion to replace or rehabilitate the Nation's deficient bridges. Pat Choate and Susan Walker, authors of *America in Ruins,*[6] conclude that these deteriorated facilities are a major structural barrier to the renewal of our national economy, and combined with an aging industrial plant, have contributed to the decline in American productivity.

The deterioration of the infrastructure adversely affects investment because often firms must bear the additional costs which result from infrastructure problems. According to a recent issue of *Business Week,*[7] U.S. Steel Corporation is losing $1.2 million per year in employee time and wasted fuel rerouting trucks around the Thompson Run Bridge in Pennsylvania, because it is in such disrepair. Companies in Manhattan, New York, lose $166 million a year for each additional five minutes delay on the public transportation systems. Old or inadequate water and sewer systems also stifle economic development. The Commerce Department reports that wastewater treatment plants in 47 percent of the communities it surveyed were operating at 80 percent or more of capacity, while the generally accepted effective full capacity utilization rate is 70 percent. As a result, new plants and homes cannot be hooked up to these systems. In older areas of the country, large parts of the water and sewer systems are almost 100 years old. Many of these systems, however, were designed for a maximum of 100 years of serviceable life.

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[6] Choate, Pat and Susan Walker, "America in Ruins." The Council of State Planning Agencies, 1981, pp. 1, 11.

[7] Business Week, October 26, 1981. p. 142.

Although discussions of the need to revitalize the Nation's decaying infrastructure often revolve around the problems of our urban centers, similar problems which plague rural America should not be minimized. Despite growth and diversification in many rural regions during the past dozen years, nagging deficiencies in rural infrastructure persist. According to a report of the General Accounting Office (GAO) issued in March 1980,[8] as much as one-half of the Nation's substandard housing may be found in rural America. Another GAO survey of rural water systems issued in August 1980,[9] revealed that many of the systems are old, underfunded, and inadequate. Statistics compiled by the Carter Administration in December 1979,[10] spoke to other problems: public transportation is used by less than 1 percent of rural people who work away from home; more than four million rural people have inadequate sewage disposal systems or none at all; more than two million do not have running water in their homes.

The economic recovery of the Nation and its urban and rural governments is dependent upon increased public and private capital investments. Historically, the two have always gone hand-in-hand—in developing manufacturing centers, and in encouraging rail, auto, and airline use and production. Public investment in economic development projects is and has always been vital to their success. However, in recent years, fiscal strain has caused many State and local officials to defer capital projects. In the short run, at least, these deferrals tend to be invisible. It is the cumulative affect of repeated postponements which threatens the utility of many facilities. More and more it appears that the public and elected officials are becomeing aware of the limits to capital deferral. While it is possible that this new awareness might result in a tapering of the decline in capital projects, the increased fiscal pressures created by a national economic downturn and massive Federal budget cuts in domestic programs are likely to prevent the reversal of this trend.

Although all but $6.5 billion of the $44.1 billion public works investment in the Nation in the most recent year for which data are available (1977) was undertaken by State and local governments, 40 percent of this investment ($15 billion) was financed through Federal grants-in-aid. This has provided the Federal Government with an important role in national public works investment. However, the cuts in domestic programs which the Administration has made and the new cuts proposed will undoubtedly alter this relationship and the course of public investment in the United States.

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[8] General Accounting Office. "Ways of Providing a Fairer Share of Federal Housing Support to Rural Areas." March 28, 1980. p. 7.

[9] General Accounting Office. "Rural Water Problems: An Overview." August 19, 1980. pp. i–v.

[10] "The Carter Administration Small Community and Rural Development Policy." December 20, 1979. p. 3.

The needs of rural America can be properly addressed only if there are adequate data on which policymakers in the public and private sectors can base their decisions. Much of the information in use today is old; it may also be less reliable and relevant than it should be. The Committee urges prompt completion of the National Rural Community Facilities Assessment Study (NRCFAS) currently underway at the Farmers Home Administration. However, in keeping with observations on economic data in other parts of this report, the Committee is concerned about the scope of NRCFAS. Originally conceived as a study of 37 different kinds of facilities in a random sample of 2,300 rural communities, NRCFAS has been restricted to five kinds of facilities in 500 communities. Such a restriction will hamper efforts to formulate rural development policies, whether by the public or private sector.

Soil Erosion

The mainstay of our rural economy, agriculture, is also, broadly defined, the Nation's largest industry. In 1979, agricultural production and marketing employed 25 percent of our labor force and accounted for 20 percent of the gross national product. In 1980, net trade in agriculture contributed $23 billion toward the purchase of oil and other things we must bring in from abroad. Underlying the enormous productive power of America's farms is the most fundamental component of rural infrastructure—topsoil. Topsoil must be maintained in good condition and protected against erosion if our cropland is to continue to produce and expand at recent rates.

The National Resources Inventory, a survey of nonfederal agricultural lands completed in 1977 and updated in 1980 by the Soil Conservation Service, revealed that the erosion of topsoil is one of the Nation's most serious long-term problems. The average annual volume of soil lost to wind and water erosion on nonfederal land is about 6.8 billion tons. The "permissible" level of yearly erosion is roughly five tons per acre since that amount is added each year by natural processes. If the rate of erosion is higher, the productivity of the land begins to decline. The gradual decline could eventually mean lower yields, higher consumer prices, increased water pollution, and possible sharp reductions in exports. Of the 338 million acres of land cultivated in 1977, about 25 percent had potential for erosion at rates exceeding five tons per acre. The problem could get worse if more marginal land is brought into production.

The Committee is very concerned about the erosion of topsoil and the potentially devastating consequences it may have for our economy if it continues unchecked. Therefore, the Committee recommends that the Federal Government broaden its commitment to the maintenance and protection of our topsoil. We urge that special attention be focused on areas where erosion is most prevalent.

Conservation tillage, in which the new crop is planted directly over the previous year's residue, is a promising development. It may cut erosion from 50 to 90 percent below that which occurs with conventional farming practices. Its drawbacks are the costly equipment it may require and the heavier use of chemicals needed to control weeds and insects, but in the long run conservation tillage may cost less than conventional methods of farming. It is estimated that, in 1979, more than one-quarter of all cropland harvested in the United States was in conservation tillage. By the year 2000, one-half may be.

Recommendation No. 21: Restore Housing

For 50 years, homeownership has been a basic objective of national economic and social policy, and the housing industry has been one of our largest employers. Yet, certain supporters of the Administration's program advocate a deliberate strategy to "shift resources" from housing into the military and into capital investment. We reject such a strategy. America's housing industry can come back, if interest rates are brought down and kept down.

The Administration and the Congress should reject proposals to dismantle or to curtail sharply the activities of the Federal National Mortgage Association, Government National Mortgage Association, and Federal Home Loan Mortgage Corporation. Sufficient funding should be provided to these institutions to ensure that they can make an adequate response to the serious needs of homeownership and the housing industry.

The Administration and the Congress should also reject proposals to dismantle further programs which help house low- and moderate-income families.

There is no single aspect of the Nation's infrastructure which directly affects more lives than the size and condition of our housing stock. And, there is no sector more dependent upon or influenced by our national economy than housing, and its allied industries.

As a result of instability in the national economy, and concomitantly high interest rates, the housing sector is experiencing its most severe and sustained contraction since 1946. It is now in its 39th month of decline from the peak of 1,525,000 units attained in November 1978. As can be seen in Table II-13, single family starts have already declined by 61.2 percent from peak to trough, and at this point we can only speculate that the trough has been reached. In no previous economic downturn has either the percentage or unit decline been so sharp. And it should be noted that this severe decline occurred before the national economy entered a recession. It is, in fact, largely attributable to skyrocketing interest rates which resulted from efforts to curb inflation through tight money. This reliance on monetary policy to curb inflation disproportionately burdens small business as well as highly interest-sensitive sectors. The housing industry is characterized by both of these attributes. The result has been a plunge in housing starts and sales, higher monthly payments to home purchasers, and unacceptably high levels of unemployment for construction workers.

TABLE II-13.—SINGLE FAMILY HOUSING START CYCLES SINCE 1965

[Seasonally adjusted annual rates]

		Units
1965–66:		
Peak month	December 1965	1,093,000
Trough month	October 1966	597,000
Unit decline		496,000
Percent decline	45.4 percent	
1969–70:		
Peak month	January 1969	967,000
Trough month	January 1970	612,000
Unit decline		355,000
Percent decline	36.7 percent	
1973–75:		
Peak month	January 1973	1,431,000
Trough month	February 1975	667,000
Unit decline		764,000
Percent decline	53.4 percent	
1978–81:		
Peak month	November 1978	1,525,000
Trough month	August 1981 [1]	591,000
Unit decline		934,000
Percent decline	61.2 percent	

[1] Cycle still in progress, and the trough may not yet have been reached.

Source: NAHB Economics Division, "Economic News Notes," October 1981.

The seasonally adjusted annual rate of housing starts (SAAR) in 1981 was 1.1 million units. This surpasses that of the previous trough year for starts—1.2 million units in 1975 and is a 16 percent reduction from the 1980 level. The 1980 level was itself 25 percent below the 1.76 million starts of 1979, and this was 14 percent below the 2.036 million units started in 1978. The National Association of Home Builders (NAHB) is predicting that total starts for 1982 will fall in the range of 1.03 to 1.3 million units. The latter estimate can be achieved, however, only if interest rates average a maximum of 14.4 percent for the year.

In addition to housing starts, sales of new and existing homes have also slipped dramatically. Sales of new homes peaked at 819,000 in 1977, declined to 530,000 in 1980, and averaged 428,000 in 1981. Sales of existing homes, which peaked in 1978 at 3,863,000, declined to 2,881,000 in 1980, and averaged an annualized rate of 2,339,000 in 1981.

The severity and continuation of the declines are largely attributable to record high interest rates. No single factor so influences housing starts and sales. In 1981, mortgage interest rate commitments on 30-year conventional home mortgages with 75 percent loan-to-price ratios averaged 16.75 percent, up from the previous record high average annual interest rate in 1980 of 14 percent. Mortgage interest rate commitments continued to climb from 15.40 percent in January to 17.53 percent in December 1981 (down slightly from the peak of 18.23 percent in October 1981).

Because high interest rates have discouraged buyers, the rate of increase in prices for both new and existing homes has fallen. The median price of new homes increased by 2.3 percent between January and December 1981—from $67,900 to $69,900, while prices of existing homes increased from $64,500 to $66,900—3.7 percent. Both new and existing home prices have fallen from their August high—by 4 percent for new, and 1.8 percent for existing homes. This compares to the 11.6 percent average annual rate of increase on new homes and 10.3 on existing homes between 1970 and 1979. Despite a slowing in the increase in housing prices, housing is becoming less affordable, particularly for first-time homebuyers. The median-priced new home in October 1981 ($71,200) required a down payment of $17,800 (25 percent) and monthly payments for principal and interest of $805 (18 percent, 30 years). Comparable figures for the same month of 1980 were $16,525, and $592 (14 percent). According to NAHB estimates, on a typical home with a $60,000 mortgage and a 30-year term, each 1 percent increase in mortgage rates puts the home out of the reach of 800,000 additional families.

Another result of high interest rates is market instability. Because lenders fear a loss of real return and businesses do not wish to lock in high interest costs for long periods of time, short-term rather than long-term loans tend to predominate. The result is higher short-term rates and more frequent refinancing. This translates into higher costs of construction to builders and higher mortgage interest rates to borrowers.

This problem is further compounded by the need for financial institutions to adjust their asset portfolios to lessen future risks. Financial institutions have been plagued by higher costs because of the higher rates available to savers in recent years as well as a preponderance of pre-1979 mortgages earning yields of 9½ percent and less. Since 1979, the financial picture for thrifts has deteriorated significantly. In 1979, the average net income of the thrift industry was $3.6 billion, for 1980, $780 million, and for the first 6 months of 1981 minus $1.5 billion. During 1980, 31 "troubled" institutions were merged with stronger savings and loan institutions and there are currently over 400 "troubled" institutions. Twelve have arranged mergers. There was one outright failure, the first in a decade.

The situation for multifamily units—those units which typically house lower and moderate income families—is equally serious. The seasonally adjusted annual rate of housing starts in structures of two or more units was 399,000 in December 1981, compared to 561,000 a year earlier. Most of the new construction appears to be in condominiums, cooperatives, or subsidized rentals. As a result of the drop-off in multifamily starts, the rental market has and continues to be very tight. The national vacancy rate was 5.0 percent for the third quarter of 1981 compared to 5.7 percent for the same period in 1980.

It is apparent that the Reagan Administration is attempting to reallocate resources away from housing to accommodate their budget goals. But, in our view, an adequate investment in housing is compatible with high levels of capital investment, a strong defense, and the continuation of programs which protect the economic and civil rights of the populace.

Secondary Mortgage Markets

The secondary mortgage market institutions have been vital in maintaining the mortgage resale market and have helped alleviate the severe pressures of tight money and the recession on the housing industry and on the thrift institutions. For the first 10 months of 1981, total secondary market purchases of home mortgages were about $45.4 billion, down from $56.9 billion in the same period in 1980. Private investors accounted for $14.3 billion; another $16.7 billion came from mortgage pools, most of which are guaranteed by HUD's Government National Mortgage Association (GNMA). The rest of the investment came from State and local investment agencies and from the Federal credit agencies such as the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA), which alone took $9.7 billion, or 21 percent of total secondary market purchases. The actions of FNMA, FHLMC, and GNMA has been particularly important when mortgage lending is being curtailed as a result of tight monetary policy because, if funds are made available, it is possible for GNMA to open its "tandem" window to buy mortgages and to resell them to FHLMC and FNMA at a discount. This was done in 1974 and 1975. The countercyclical tandem program, still on the books, expires this year, however.

The secondary markets also have an important regional impact on the flow of mortgage funds. In those areas where housing markets tend to be brisk but savings flows low, it is possible to continue lending by selling mortgages to investors from areas with more capital and less activity. As a result, there is less regional variation in interest rates than there might otherwise be, and therefore less tendency for one region of the Nation to be more affected by interest rate cycles than others.

Recommendation No. 22: Science and Technology

> **Administration proposals to curtail sharply government support for civilian research and development, and to impose new requirements on scientists to submit to government censorship because of possible national security concerns, threaten to force sharp reductions or shutdowns of government laboratories and reductions in the supply of trained manpower for industry and universities, to diminish the level and quality of university-based research, and to lessen the contributions of science and technology to improvements in the growth of productivity. Congress should reject such proposals.**

Among the many casualties of the Administration's approach to the budget, research and development (R&D) causes us some of our greatest concern. The reason is that R&D is an indispensable link in the chain of activities that leads to technological progress. The Administration has already weakened this link with respect to the national economy and threatens to further weaken it and the quality of science and technology.

In discussing R&D it is important to keep in mind the differences between defense and civilian research. Both are important, but for different reasons. The uniqueness of the defense mission and the increasing specialization of defense technology reduces the likelihood of civilian benefits from defense R&D. It is therefore distressing to witness the Administration's emphasis of defense R&D at the expense of civilian R&D.

Total spending for R&D in the United States will be about $80 billion in fiscal year 1982. Half of this amount is spent by the Federal Government. Federal R&D spending, adjusted for inflation, will rise modestly from fiscal years 1980 to 1982 only because of the rise in defense R&D. Civilian R&D declines in real terms during this period. As shown in Table II-14, Federal spending for R&D, in current dollars, rises from $33.1 billion in fiscal year 1980 to $40 billion in fiscal year 1982. Defense R&D rises from $15.4 billion to $22.4 billion, while nondefense R&D falls slightly from $17.62 billion to $17.56 billion in the same period. However, in constant dollars, defense R&D rises 22.1 percent from 1980 to 1982, while nondefense R&D declines 16.2 percent in the same period.

TABLE II-14.—TRENDS IN FEDERAL RESEARCH AND DEVELOPMENT FUNDING, INCLUDING PLANT AND FACILITIES, TOTAL AND SELECTED MAJOR AGENCIES, SELECTED YEARS, CURRENT AND CONSTANT 1972 DOLLARS [1]

[Expressed in millions (Note: Constant 1972 dollars are bold)]

	Obligations by fiscal year		Budget authority data by fiscal year			
	1972 actual	1975 actual	1980 actual	1981 est.[2]	1982 request March 1981 estimate [3]	1982 Congressional action, estimate data
Total federal research and development		$19,860	$33,054	$36,960	$42,215	$39,955
	$17,098	**16,133**	**18,706**	**19,101**	**20,093**	**19,017**
Defense			15,430	18,988	23,993	22,393
	N.A.	**N.A.**	**8,732**	**9,813**	**11,420**	**10,658**
Nondefense	N.A.	N.A.	17,624	17,973	18,222	17,562
			9,974	**9,288**	**8,673**	**8,359**
Total Federal basic research		2,600	4,716	5,013	5,542	5,320
	2,223	**2,112**	**2,669**	**2,591**	**2,638**	**2,532**

TABLE II-14.—TRENDS IN FEDERAL RESEARCH AND DEVELOPMENT FUNDING, INCLUDING PLANT AND FACILITIES, TOTAL AND SELECTED MAJOR AGENCIES, SELECTED YEARS, CURRENT AND CONSTANT 1972 DOLLARS [1]—Continued

[Expressed in millions (Note: Constant 1972 dollars are bold)]

	Obligations by fiscal year		Budget authority data by fiscal year			
	1972 actual	1975 actual	1980 actual	1981 est.[2]	1982 request March 1981 estimate[3]	1982 Congressional action, estimate data
Total Federal basic defense research (DOD and military DOE)	N.A.	N.A.	552	616	723	699
Federal R and D, selected major agencies:			**312**	**318**	**344**	**333**
Department of Defense		9,180	14,021	17,322	22,104	20,597
	8,493	**7,457**	**7,935**	**8,952**	**10,521**	**9.803**
Department of Energy	N.A.	N.A.	5,768	5,867	5,524	5,503
			3,264	**3,032**	**2,629**	**2,619**
Department of Health and Human Services (previously HEW)		2,437	3,806	3,971	4,173	3,987
	1,806	**1,980**	**2,154**	**2,052**	**1,986**	**1,898**
(National Institutes of Health)		1,918	3,188	3,325	3,585	3,476
	1,321	**1,558**	**1,804**	**1,718**	**1,706**	**1,654**
National Aeronautics and Space Administration		3,207	5,243	5,523	6,122	5,938
	3,202	**2,605**	**2,967**	**2,854**	**2,914**	**2,826**
National Science Foundation		618	912	934	1,018	970
	473	**502**	**516**	**483**	**485**	**462**
Environmental Protection Agency		258	342	363	304	277
	123	**210**	**194**	**188**	**145**	**132**

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[1] All current dollars data for fiscal year 1972 and fiscal year 1975 are from: U.S. National Science Foundation. Federal Funds for Research and Development, Detailed Historical Tables: Fiscal years 1970–82, Prepared by Moshman Associates, Inc., 1981. Current dollars data for fiscal year 1980 and later are from Shapley, Willis H., Albert H. Teich, and Jill P. Weinberg. Congressional Action on Research and Development in the fiscal year 1982 Budget. Washington, American Association for the Advancement of Science, January 1982. CRS computed constant 1972 dollars, using NSF-supplied deflators.

[2] As expressed in March 1981 budget request for fiscal year 1982.

[3] Includes June budget amendment for defense of +$45.7 million.

These trends would have been more exaggerated had not Congress moderated the Administration's budget proposals last year by trimming the defense R&D increases and the civilian research cutbacks.

But the Administration's proposal for Fiscal Year 1983 demonstrates an intent to continue cutting back on civilian R&D including basic research. As Table II–15 shows, the Administration again proposes that defense R&D be increased while civilian R&D is reduced in real terms. Table II–16 shows the trend in Federal funding for basic research. Under the Administration's proposal, defense basic research would increase by 11.6 percent between Fiscal Year 1981 and Fiscal Year 1983, while civilian basic research declines by 4.5 percent during the same period.

The Administration's retreat from support of civilian basic research is especially troubling. Because of the role basic research plays as a long-range investment for the entire Nation, it is properly a Federal responsibility. The case can be made that support for basic research should be increased rather than cut back.

Coupled with the budget initiatives are efforts by Administration spokesmen to urge university scientists to submit their work to government censorship because of possible national security concerns and to restrict the free flow of scientific information at universities.

In an industrial economy such as ours, one of the most important factors influencing the growth of productivity is the technological progress that springs from advances in knowledge made possible by R&D. Although there is considerable controversy about the precise contribution of technological change to the rate of growth of productivity and GNP, it is agreed that the contribution is important. It is also agreed that the rate of technological change has not been rapid enough to achieve adequate productivity growth and that skilled manpower shortages are hampering the ability of high technology industries to expand.

The Administration recognizes the importance of new technology to economic vitality and international competitiveness, and it acknowledges the decline in innovation in industry and the shortages of skilled workers, especially in computer sciences and engineering. The Administration believes that its decision to increase spending for defense R&D while cutting back on civilian R&D is justified by the needs for a defense buildup and for reducing nondefense spending.

TABLE II-15.—TRENDS IN CONDUCT OF [FEDERAL] R. & D., SELECTED YEARS, CURRENT AND CONSTANT DOLLARS

[Obligations in billions of dollars] [1]

Year	Defense [2]	All other	Total
1972	8.9	7.6	16.5
1975:			
Current dollars	9.7	9.3	19.0
Constant 1972 dollars	7.88	7.55	15.43
1979:			
Current dollars	13.6	15.4	29.0
Constant 1972 dollars	8.35	9.46	17.81
1980:			
Current dollars	15.1	16.6	31.7
Constant 1972 dollars	8.5	9.39	17.94
1981:			
Current dollars	17.8	17.2	35.0
Constant dollars	9.19	8.88	18.08
1982, estimate:			
Current dollars	22.1	16.8	38.8
Constant 1972 dollars	10.56	8.03	18.5
1983, estimate:			
Current dollars	26.2	16.8	43.0
Constant 1972 dollars	11.75	7.53	19.29

[1] Deflators supplied by NSF are 1975, 1.231; 1979, 1.628; 1980, 1.767; 1981, 1.935; 1982, 2.093; 1983, 2.229.

Current dollars data are taken from table K-9, "Trends in Conduct of R. & D.," in U.S. Office of Management and Budget, special analysis K, research and development, budget, 1983. February 1982, p. 29.

[2] According to source, this includes military-related R. & D. programs of the Departments of Defense and Commerce [energy].

Source: Congressional Research Service.

TABLE II-16.—TRENDS IN FEDERAL FUNDING FOR BASIC RESEARCH, FISCAL YEAR 1981 TO FISCAL YEAR 1983, CURRENT AND CONSTANT DOLLARS, DEFENSE AND CIVILIAN, OUTLAYS

[In millions of dollars] [1]

	Fiscal year 1981, estimate		Fiscal year 1982, estimate		Fiscal year 1983, estimate		Percent change in constant 1972 dollars between fiscal year 1981 and fiscal year 1983
	Constant 1972 dollars	Current dollars	Constant 1972 dollars	Current dollars	Constant 1972 dollars	Current dollars	
Defense	286.3	712	294.3	616	319.4	712	+11.56
Civilian	2,284.75	4,975	255.61	4,721	2,181.24	4,862	−4.53

[1] Deflators supplied by NSF are 1981, 1.935; 1982, 2.093; 1983, 2.229.

Current dollars data taken from table K-3, "Conduct of Basic Research by Major Departments and Agencies," in U.S. Office of Management and Budget, special analysis K, research and development, budget, 1983. February 1982, p. 7.

Source: Congressional Research Service.

According to the Administration, the incentives contained in the Economic Recovery Tax Act of 1981 will stimulate an additional $3 billion in industrial R&D over the next five years. The removal of unnecessary regulatory barriers to industrial innovation will reduce private-sector costs of compliance and promote the use of research funds more productively. The problem of shortages of scientists and engineers, the President's science advisor has stated, should be left to the marketplace.[11]

The Administration's approach is flawed and likely to impede technological progress for several reasons:

The Administration's civilian R&D cuts have been deep and disruptive and are not likely to be offset by increased private spending.

The budget reductions will reduce the number of trained scientists and worsen the shortages of skilled workers for civilian high technology firms.

The proposed cutbacks in civilian basic research and other civilian research activities will severely affect future funding of university-based research, and government research in such areas as energy, biomedicine, and environmental pollution.

The cutbacks in funding for the national laboratories have disrupted ongoing research projects.

The Administration's initiatives have created great uncertainty in the science community and doubts about the Federal Government's commitments to advances in science and technology.

Elsewhere in this Report, we have criticized the sole reliance upon tax incentives to induce greater private spending for investment. The same criticism applies in the area of tax incentives to increase industrial spending for R&D. The disappointing results so far in the area of overall business investment strongly suggest that the Administration's expectations concerning industrial research spending are likely to be unfulfilled.

The effects of continuing the reductions over the next several years could be crippling to the national laboratories and university-based research. The Administration's desire to increase the level of industrial research is commendable. However, increases in industrial research, even if they occur, would not justify the damage being done to the nonprofit research institutions where much of the Nation's basic and longer term research is conducted. Although the new tax Act allows businesses to use research grants to universities for R&D tax credits, there are not special incentives for such grants in the Act. As a result, it is possible that only a small amount of the tax credits will be used for university research.

These matters were the subject of discussion at a conference convened on October 26–27, 1981, by the National Academy of Sciences between a group of about 100 university officials, scientists and engineers, and members of the Administration. There the scientists registered in the strongest terms their objections to the Administration's proposals. They warned that "Irreversible damage" could occur in longer term research, that "instability and abrupt" changes in funding cause research teams to be broken up and expensive laboratory equipment such as accelerators to be poorly used, and that the continued supply of scientists and engineers could be jeopardized.

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[11] George A. Keyworth, testimony before the House Committee on Science and Technology, December 10, 1981.

It is apparent from the Administration's handling of the R&D program that it has not adequately taken into account the needs of the research community and the role it plays in long-term as well as short-term technological progress. The research proposals appear to have been merely a by-product of the decision to reduce overall government spending. While government R&D activities should not be exempt from the needs to eliminate waste and achieve economies, the long-term damage to the economy from a poorly planned meat-axe approach in this area will exceed the budgetary savings.

Recommendation No. 23: Labor

> **The Committee rejects efforts by the Administration to deemphasize the role of labor in the production process. In the face of massive and growing unemployment, Federal manpower training programs should be maintained at least at reduced Fiscal Year 1982 levels. Greater private participation in the design and conduct of Federal manpower programs is warranted.**

The sharp rise in unemployment during 1981 was exacerbated by a substantial reduction in Federal resources devoted to the training of our Nation's labor resources. The neglect of manpower training and of programs to assist low-skilled persons also impedes economic recovery and prospects for improving productivity.

Department of Labor outlays for job and training programs will decline to some $4.5 billion in Fiscal Year 1982 from $7.8 billion in 1981 despite the addition of 1.7 million more men and women to the unemployment rolls. The Administration further estimates that only $2.4 billion will be needed for such programs in Fiscal Year 1983. Proposed program changes include abolition of the existing Work Incentive Program to training and place welfare clients, most programs under the Comprehensive Employment and Training Act (CETA), the summer jobs program, and training conducted under the Trade Adjustment Assistance Act.

Some 340,000 public service jobs under CETA were already eliminated in the Fiscal Year 1982 funding reduction. Under proposed Fiscal Year 1983 Administration plans, no Federal public employment programs would exist. The remaining programs for job training and other services would be further consolidated into block grants to States, with reduced levels of funding compared with CETA. The new grants would also prohibit States from using the money for public jobs programs or to pay stipends to participants of training programs. The only current Department of Labor manpower programs to be continued under these projections would be the Job Corps ($387 million in Fiscal Year 1983) and job and training programs for migrant workers, American Indians, and the elderly ($274 million).

This proposed transition in Federal manpower programs by Fiscal Year 1983 would reduce by almost half the current Federal labor training effort. It would virtually eliminate the already scant Federal effort to retrain workers with obsolescent skills, programs which are at the forefront of labor training programs in most other industrialized nations. It would shift to employers an even larger responsibility to provide remedial and elementary job training to new workers. And, with the exception of some assistance available from jobs tax credits, employers will bear the full burden of retraining mature workers. Given the severity of this recession, there is no indication that employers are willing or able to expand their existing commitment to train workers.

Recommendation No. 24: Needed: Skilled Labor

> **Maintenance of existing youth and unskilled labor training commitments should be accompanied by a comprehensive review of Federal training programs to meet the emerging need for additional adult retraining programs. Youth and adult training programs should emphasize emerging skilled occupations and employers should be encouraged with tax credits to fill labor-short skilled occupations through expanded on-the-job training. Special attention must be given to the skilled labor needs of small business in the design of new training initiatives.**

Demographic changes facing the United States in this decade will require a revision in the focus of Federal employment and training programs. Outlays for such programs totaled almost $17 billion in Fiscal Year 1981, and will exceed $13 billion in Fiscal Year 1982 despite the sharp reduction in CETA funding. An additional $6 billion is being provided by State and municipal authorities in Fiscal Year 1981 in matching funds for 27,000 high school or postsecondary level vocational programs. The bulk of these public education and training outlays are targeted at youths through CETA, guaranteed student loans, Pell grants, and vocational education programs.

Adult education and training programs are funded largely under the Rehabilitation Act, the Senior Community Service Employment program, the Veterans Administration, the Trade Adjustment Assistance program, and the Adult Education Act. A few CETA programs, such as the Work Incentive Program and Vocational Education, also provide some adult training. Altogether, about one-third of all Federal employment and training funds reach adults, and less than one-half of these adults are in retraining programs.

The overwhelming focus of Federal employment and training programs on youths and unskilled adults reflects in some degree the demographic reality of the last decade, when an unprecedented number of Americans entered the labor market. The civilian labor force increased by 24.2 million persons from 1970 to 1980, a 29.2 percent jump. In comparison, it grew barely 13 million persons during the 1960's, or 18.3 percent. And from 1950 to 1960, the domestic labor force grew even less, rising by only 6.4 million persons, or 11.9 percent.

Most but not all of these new workers found employment. Over 20 million new jobs were created in the 1970's, compared to 13 million in the 1960's. In ordinary times, such a pace of job creation would be cause for celebration. But the rise in labor force entrants during the 1970's was even greater than the rise in jobs.

The surge of new workers meant that the ratio of capital to labor fell. One study found, for example, that new real capital investment per worker added to the labor force in the last decade was almost 20 percent below the investment level attained in the 1960's. And the economy's capital-employment ratio declined an average one-tenth of 1 percent each year from 1974 to 1979, after rising over the previous 25 years at an annual average rate exceeding 2.9 percent.

With the quantity of capital available per worker declining, it is scarcely surprising that U.S. productivity fell in the latter 1970's. That phenomena also partly explains the curious situation which our Nation confronted in that period where productivity fell, despite a higher share of business fixed investment in GNP, almost 1 percentage point above the rate attained in the 1950's and 1960's.

The most pronounced effect of this sharp rise in our labor force was a leap in unemployment. Unemployment averaged 6.3 percent over the last decade or nearly 6 million men and women unsuccessfully seeking work. Not once in any of the preceding 29 years from 1941 to 1970 did the average annual number of unemployed Americans even approach the average level of unemployment our Nation experienced throughout the entire decade of the 1970's.

The 1970's did indeed give a new meaning to the term "unemployment." Year after year, the number of unemployed workers scored levels not seen since the 1930's. For minorities, double-digit unemployment rates were commonplace. And for minority teens, the best year of the last decade—1973—for them resembled 1933 when national unemployment for everyone hovered at 25 percent.

Two major forces accounted for the surge in labor force growth during the 1970's: the maturation of the World War II baby boom and growth in the number of working women. The bulk of the postwar baby boom entered the labor force in the 1970's. For example, while the total labor force grew 29.2 percent over that decade, the number of workers between ages 16 and 24 grew 42 percent to exceed 25 million, and now comprise one-fourth of the entire U.S. labor pool. An even faster rate of growth was scored by working women during the 1970's. The number of women working outside the home soared 42 percent from 1970 to 1980, propelled by a desire to supplement stagnating real family incomes, the trend toward delayed marriages, and changing social attitudes toward working women. As a consequence of these trends, four out of every 10 working Americans today are women, up from one in three in 1960.

The rise in numbers of working women is reflected in data on their labor force participation rates. In 1960, only 37.7 percent of U.S. women 16 years or older were employed or seeking employment. That participation rate eased up to 42.7 percent by 1969 as shown in Table II-17. But by 1978, that figure had increased to 50 percent and rose to 52.1 percent in 1981. Continuing a traditional pattern, the labor force participation rate for minority women in 1981 ran ahead of the rate for all women.

TABLE II-17.—LABOR FORCE PARTICIPATION 1960-81

[In percent]

Year	Participation rates [1]		
	Total	Males	Females
1960	59.4	83.3	37.7
1961	59.3	82.9	38.1
1962	58.8	82.0	37.9
1963	58.7	81.4	38.3
1964	58.7	81.0	38.7
1965	58.9	80.7	39.3
1966	59.2	80.4	40.3
1967	59.6	80.4	41.1
1968	59.6	80.1	41.6
1969	60.1	79.8	42.7
1970	60.4	79.7	43.3
1971	60.2	79.1	43.4
1972	60.4	78.9	43.9
1973	60.8	78.8	44.7
1974	61.3	78.7	45.7
1975	61.2	77.9	46.3
1976	61.6	77.5	47.3
1977	62.3	77.7	48.4
1978	63.2	77.9	50.0
1979	63.7	77.8	50.9
1980	63.8	77.4	51.5
1981	63.9	77.0	52.1

[1] Civilian labor force as percent of civilian noninstitutional population.

Source: Bureau of Labor Statistics.

With a labor force participation rate of 77.0 percent in 1981, the share of males working still exceeds that of females. Yet, the trend of men participating in the labor force is opposite that of women. In fact, since attaining a postwar peak of 86.6 in 1948, the participation rate for men has trended down fairly steadily, although the rate of decline slowed some in the 1970's.

Women: Losing Ground

Women still experience substantial problems in the labor market, despite these major changes in their labor participation. Compared with men, women have much less access to jobs with good pay and advancement opportunities. Even for women who worked full time all year round, median earnings in 1980 were only 60 percent as high as for men—a percentage that has changed little in two decades. The pay gaps are closely related to occupational characteristics: women remain concentrated in clerical, service, and other low-wage occupations and scarce in a wide variety of professional, technical, and managerial fields. And millions of unskilled women living in poverty cannot obtain employment even in low-wage, predominantly female jobs.

The Administration's economic policies, by causing a severe recession and by deep cuts in programs of proven help to women, will aggravate these hardships and inequalities. "It is not an exaggeration to say that the Reagan Administration has declared economic war on women, particularly on those women who do not have a man to depend on," according to testimony by Dr. Barbara Bergmann, Professor of Economics at the University of Maryland, at a hearing on "The Economic Status of Women," on February 3, 1982.

Since the recession began in July of 1981, unemployment among women has increased significantly. Although the male unemployment rate is higher, due to the industrical compositon of job losses, approximately 4 million women were jobless and another 2.7 million were working part-time involuntarily. Further, the recession may be forcing many others to settle for lower-paying jobs than they might otherwise have gotten.

According to testimony received by the Committee at the February hearing, women will also suffer disproportionately from the following aspects of the Reagan program:

> *Cuts in spending for public jobs and training.* Though they reach only a fraction of the women in need, CETA job and training programs did benefit those who participated. Studies that follow CETA participants for several years after leaving the programs have found that poor women experienced considerably greater improvement in employment and earnings than other groups. Participation in CETA generally equipped these women with basic skills that enabled them to obtain clerical jobs. Some programs also emphasized the placement of women in nontraditional jobs and provided help with child care problems and other supportive services.
>
> *Cuts in AFDC, Food Stamps, and other income transfer programs.* The Administration chose to cut welfare costs by reducing benefits to the working poor. As a result, millions of female-headed households whose poverty rates are already high, will become more, not less, dependent on welfare than before. The cumulative impact of the Administration's changes is to raise the implicit marginal tax on the earnings of a welfare mother as high as 95 percent, leaving a welfare mother who works with no more than 5 cents of every dollar she earns.
>
> *Across-the-board cuts in funding for day care and child support enforcement.* Until the Reagan Administration took office, a Federal program to help States locate absent fathers and enforce child support obligations was collecting well over $1 billion a year above its costs, thus reducing the burden of child support on the welfare system. And, as the number of preschool-aged children with working mothers is expected to double between 1980 and 1985, the need for day care facilities will rise, not decline, if there is to be a realistic hope that these women can escape permanent dependence on welfare.

Weakening antidiscrimination activities. Budget cuts threaten to severely hamper the enforcement efforts and increase the backlogs of Federal agencies responsible for equal employment opportunity and affirmative action policies. Potentially most damaging, however, are Administrative attempts to ease affirmative action requirements for government contractors and to limit the remedies sought by government in cases of employment discrimination.

A Labor Scarcity To Come?

The past decade of labor abundance and poor productivity growth is giving way to one of potential scarcity as the "baby-bust" generation matures. Labor force growth this decade will reflect the effects of a declining national birthrate.

The birthrate declined for 18 years after 1957, when it was 25.3 births per 1,000 population. It fell sharply in the following baby-bust years to a low of 14.8 by 1975.

Since then, the birthrate has risen slighty. For example, it was 16.2 in 1980, as women born in the postwar baby boom entered childbearing years. Natural replacement of the population would require that each woman of childbearing age average 2.1 children. the Current 1.7 rate is below that replacement level and well below The 3.7 rate attained in the peak baby-boom years of the 1950's.

The baby-bust generation will come of age in this decade. The result will be a marked slowing in the growth of the working age population and of new entrants to the job market. For example, only 16 million men and women will be added to our entire potential labor pool—the noninstitutional population over the age of 16—this decade from which our Nation's workforce is drawn. This growth is far below the 30 million added to our potential workforce in the 1970's and even below the 20 million added to that pool in the 1960's. It is below, as well, the number of net new jobs—19 million—which were created during the 1970's.

Consequently, employers will face labor shortages this decade if our economy creates anywhere near as many jobs as it did in the 1970's. If there is a higher participation rate of older workers in the labor market, such shortages may be avoided. Those adult workers delaying retirement for a year or two will not require training. But adult workers lured back into the job market by rising wages may well lack broad job skills in a fashion similar to working mothers who entered the job market in the past decade. These adult workers will not be interested in extended training periods at four-year colleges or perhaps even two-year schools. They will be enticed to rejoin or remain in the workforce by rising wages and will be generally unwilling to postpone receiving those wages during lengthy training periods. Targeted retraining programs will be necessary to meet their requirements.

The reentry of substantial numbers of adult workers is not the only or even major phenomena which our labor training system must accommodate this decade.

The rapidly evolving application of electronics to many facets of our economy brings into question our ability to provide training for the type of jobs to be available in the future. The level of sophistication and variety of electronic aids to business has reached major proportions—electronic mail sorters, production line robots, bank tellers, and word processors, to mention a few. These devices are rapidly changing the way our society produces and exchanges goods and services, a change unprecedented in the number of jobs it is creating as well as eliminating, and in the new demands being placed on existing occupations. The Department of Labor estimates that some 80,000 new jobs will be created annually through 1990 for systems analysts, programmers, computer technicians and operators, and keypunch operators. And, if you include the effect of retirement, a total of some 105,000 new workers in these occupations will be needed each year.

Labor Department data suggests that 2,500,000 or more skilled jobs will be created this decade for which training capabilities do not now exist. The search for students to fill shrinking secondary and post-secondary classrooms should ease this training capability gap. Yet, employers will face an unprecedented challenge in the years ahead to conduct on-the-job training for increasingly complex jobs.

They will be forced, as well, to rely on a typically high proportion of adult and even retired workers to fill those training slots.

An objective of the Economic Recovery Tax Act of 1981 is to boost productivity by fostering increases in savings and investment. The development of an educated, motivated, and skilled workforce is also necessary to improve productivity. Improving skills through public training programs is an objective which this Committee believes should return to prominence as we seek to boost our lagging productivity performance.

Small Business and Job Creation

On the average, at least 60 percent of all jobs in the United States are generated by firms with 20 or fewer employees. About 50 percent of all jobs are created by independent, small entrepreneurs.[12]

In order to sustain an increase in the number of small firms and small business employment, it is essential that we address the employment problems which small firms experience. Since any economic recovery will increase the demand for skilled workers, the lack of an adequate supply of skilled workers could be a critical bottleneck to such a recovery. And smaller firms, less able to carry substantial overhead than larger firms, will bear the brunt of skilled labor shortages.

The major cause of the disproportionate burden of the looming shortages of skilled workers which will be borne by small business is the cost of training. During joint hearings on "Economic Programs to Stimulate Employment in the Small Business Sector," in April of 1981, by the House Education and Labor Committee and the House Small Business Committee, the National Tool Association estimated that the cost of training a skilled worker in a four-year apprenticeship is approximately $30,000. For this reason, there are very few small businesses with adequate training programs for skilled jobs. In addition, the pronounced cyclical nature of small business dampens a firm's ability to develop such substantive training programs. Finally, small firms are unable to divert skilled workers away from production to conduct training because of the adverse effect on productivity.

There are inadequate incentives for business, especially small business, to hire and train skilled workers or to upgrade the skills of the existing workforce. In the absence of these incentives, skilled labor shortages this decade will contribute both to inflation and lagging productivity growth.

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[12] David Birch, "The Job Generation Process," Cambridge, Massachusetts: MIT Program on Neighborhood and Regional Change, 1979. Report submitted to the Econonic Development Administration, U.S. Department of Commerce.

Targeted Jobs Tax Credit

The ERTA extended and modifed the targeted jobs tax credit, which provides credits of up to $3,000 in the first and $1,500 in the second year of employment for individuals hired from one or more of seven target population groups. The ERTA extended the credit to eligible employees hired before January 1, 1983. It repealed the provision that limited qualified first-year wages to 30 percent of the Federal Unemployment Tax Assessment of FUTA.

The Act included several modifications to previous law related to eligibility and certification. The tax credit provisions were extended to certain categories of welfare recipients and a separate credit for participants in the WIN program was repealed. The Act removed the 35-year old age limitation for Vietnam veterans and made eligible those workers laid off from the Public Service Employment Title VI program. Although these changes in the law were useful, they do not adequately address the need to facilitate the training of youths and adults for those skilled occupatons experiencing shortages in industries critical to our Nation's long-term economic recovery and health. Other modifications in the targeted jobs tax credit should be studied by Congress, as well. Study should be given to applying them against payroll or other taxes rather than against taxable profits, for example. It is estimated that 40 percent of the firms with capital assets under $5 million do not pay income taxes; most of these firms would not find the targeted jobs tax credit useful.

Another proposal to make the targeted jobs tax credit more effective was advanced by John Bishop during the joint hearing noted earlier.

Under this proposal, firms would receive a tax credit against social security taxes of $1.00 per hour for every hour by which total hours worked for both labor and management at the firm in 1982 exceeds total hours worked in 1980. The credit would apply in 1983 for increases in total hours worked over the higher of 1982 or 1980's hours worked. The 1984 tax credit would be for increases in total hours worked over the highest previous year. The tax credit could also incorporate an anti-inflation feature, which would reduce the size of the credit if average wages increase by more than a specified rate. Bishop asserted in his testimony that the employment subsidy would be attractive because of five basic features:

(1) Firms are encouraged to increase employment by hiring inexperienced workers and training them rather than by increasing overtime work or bidding experienced workers away from other firms by raising wages.

(2) Within each firm, it tends to target the employment stimulus on the least skilled workers because hiring lower wage workers lowers the average wage of the firm.

(3) Targeting on less skilled workers is accomplished without giving low-wage firms a proportionately larger subsidy.

(4) Firms are encouraged to slow the rate at which they increase wages.

(5) Both marginal and average costs of production are reduced while wage increases above the standard are taxed simultaneously.

We believe this proposal deserves serious consideration.

Recommendation No. 25: Federalism

State and local governments have borne a disproportionate share of FY 1982 budget cuts and fiscal distress is widespread. At the same time, promised benefits from the Administration's Economic Recovery Program have not materialized for most cities and States. Additional budget cuts which adversely affect State and local governments should not be made in FY 1983.

If and when additional consolidation of categorical grant programs into block grants are considered, they should be introduced gradually, so that States and localities can do the necessary planning without unnecessary disruption. We reject the effort to use block grants as a vehicle to force service cuts.

We support efforts of State and local government officials to begin a "sorting out" of Federal, State, and local responsibilities. However, we believe that because the design and functions of government are extremely complex and technical, they cannot be recast with the mere stroke of a pen. This process requires careful planning and deliberation.

At the same time, we believe the Federal Government itself must be made to work more efficiently and deliver better results with the taxpayers' dollars. We endorse the Bolling-Roth bill to create a Presidential Commission on More Effective Government.

We urge that the Commission be set up quickly so it can begin to grapple with the complexity of making government work better at all levels.

The contribution of the Federal Government to the State and local sectors has been waning since 1978. At that time, for each dollar of own-source general revenue, Federal aid represented $0.26 to municipalities, compared to $0.23 in 1980. Federal aid which comprised 3.6 percent of the GNP in 1978, slipped to 3.0 percent in 1981. And Federal aid, which increased at an average annual rate of almost 15 percent between 1958 and 1978, increased by only 6.9 percent per year between 1978 and 1981, and actually fell by 7.3 percent in 1982.

Neither a slowdown in Federal assistance to State and local governments nor the perceived need for a "New Federalism" is a new idea. Both Presidents Nixon and Carter proposed consolidations of a number of discrete programs in efforts to simplify their administration, increase the discretion of State and local governments in the use of Federal funds, and increase State and local responsibility. While these previous administrations may have set the tone for a "New Federalism," and while many State and local officials supported the need for an overhaul of the existing system, few envisioned that this would occur so quickly or dramatically and with so little input from the affected parties. Less than a year into the Reagan Administration, some 57 State and local programs were consolidated into nine new or modified block grants at funding levels approximately 25 percent below the levels of the individual categorical programs.

In addition, in the first round of FY 1982 budget cuts, reductions in grants to State and local governments represented $12 billion, or one-third of the total cuts, despite the fact that State and local grants represented only 12.6 percent of total Federal outlays in FY 1982.

It appears that the President is intent on achieving his goal of "taking the country back as far as the Constitution" [13] in terms of Federal, State, and local relations. While the Reagan Administration seems to be committed to extricating the Federal Government from State and local affairs, it does not appear that most State and local governments are capable of assuming the responsibility for managing and financing many programs now funded by the Federal Government. So, if the Administration's goal truly is to shift the responsibility for financing and administering programs to the State and local level, they may achieve a theoretical victory only, since in most instances adequate resources are simply not available. If, on the other hand, the actual agenda is to terminate many of those programs now funded by the Federal Government, it seems that this goal will more readily be achieved. Many States and cities, unable to maintain current service levels, are in no position to assume additional administrative or fiscal responsibilities.

The President has stated, however, that the 1982 "budget is more than a slowing of the growth rate of government; it reorders national priorities, seeking to return discretion, flexibility and decisionmaking to the State and local level." [14] Perhaps this statement of goals for our Federal system should be evaluated against the reality of what has occurred.

The Administration initially proposed consolidating approximately 80 categorical programs into seven new or existing block grants. The Administration's intent was to authorize the purposes of the programs being consolidated and to allow the States to design and oversee programs to meet these purposes. To achieve this, many existing laws were proposed to be repealed and the States were to be given the option of continuing to perform or fund these activities under the rubric of a block grant. At the same time, however, the funding levels proposed for each of the block grants were reduced by approximately 25 percent below the levels of their component programs. The reduction in funds was justified on the grounds that all of the administrative, planning, audit, and pre-approval requirements would have been eliminated and thus States would have benefited from savings on administrative costs. In addition, it was argued that, though the funds were limited, they would better serve the needy because it is a lot easier and cheaper "to get on a cross-town bus and go to city hall to go to the State Capitol than it is to get to Washington."

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[13] "New York Times," November 22, 1981, p. 1.

[14] Speech before the National Conference of State Legislatures, July 30, 1981.

There is, however, more agreement on the need for Federalism reform than on the approach this should take. A study of the Federal system conducted by the Advisory Commission on Intergovernmental Relations (ACIR) identified four major problems requiring attention:

Administration.—There is too much red tape and too little coordination and cooperation between Federal, State, and local administrations.

Effectiveness.—Federal programs are marked by poor performance and inadequate results.

Costs.—Federal programs are plagued by administrative waste.

Accountability.—There has been substantial weakening in the responsiveness of government and in its accountability to the people.

Whether block grants adequately address these problems is still subject to debate. The Committee held three days of hearings on block grants between July and September 1981. The major concerns expressed by the witnesses were as follows:

(1) *Program Accountability.*—Many of the witnesses cited the need for the Federal Government to state its specific objectives as clearly as possible in order to facilitate program implementation and oversight. According to Paul Dommel of The Brookings Institution:

> . . . the decentralizing goal of any block grant should be flanked legislatively with meaningful elements of accountability, the most important being specification of national objectives, a formal application process with a Federal opportunity to say "no," citizen particitation, and a policy evaluation system.

(2) *Adequacy of Funding Levels.*—This was a concern shared by just about every witness who testified. Governor Orr of Indiana indicated that Federal funding cuts for the block grants alone will have a "$25 million impact on Indiana." "Indiana," he continued, "will not pick up these lost Federal funds. We cannot afford to do so." Similarly, John J. Gunther, Executive Director, U.S. Conference of Mayors, expressed the concern that "a level of funding that provides only 75 percent of current funds will result in substantial cutbacks in services."

(3) *States' Abilities to Distribute Funds Equitably.*—Intense debate continues as to the ability of States to administer block grants in an equitable fashion. Several of the witnesses, including Ronald F. Gibbs, National Association of Counties, favored block grants "that leave decisions about programs to the local level where the services are delivered in order to preserve the safety net of life-sustaining services that counties must operate." Others, including John Thomas, Assistant Minority Leader, Indiana House of Representatives, representing the National Conference of State Legislatures, argued that "State legislatures are the logical place for the discussion and resolution of State-local concerns." He cited evidence that, over the years, States have been more responsive to their local governments, have increased aid to localities, and have become more resourceful in their financial and tax structures. Ste-

phen B. Farber, Executive Director of the National Governors Association, indicated ". . . States have undergone tremendous changes in the last 20 years and, along with better local management, now represent the best hope for the future of our communities . . ." However, as William H. Hudnut III, Mayor, City of Indianapolis, testified, ". . . there have been great problems in terms of establishing a good working partnership and relationship between the State government and local government. There is a perception . . . around the country that State legislatures are . . . insensitive to the problems of the cities and the plight of the urban disadvantaged."

Similar disagreement surfaced over the likelihood of recipient equity being maintained by the States. Lester Salamon of the Urban Institute cited evidence that ". . . block grants lead to substantial departures from Federal purposes, particularly those purposes related to the targeting of benefits on those in greatest need." Frank G. Tsutras, Director of the Congressional Rural Caucus, predicted the emergence of "a brutal political struggle . . . where the most vulnerable and those without clout are almost certain losers." David Walker, of ACIR, however, foresees a "mixed picture on the equity issue," and indicated that nine to ten States have targeted funds well over the course of past years.

(4) *Administrative Capability of States.*—There was little disagreement that sharp funding cuts would limit the ability of most States to administer the block grants. As Richard Hatcher, Mayor of Gary, Indiana, indicated, ". . . the States will have to assume increased administrative responsibilities and I am really hard put to know where the resources . . . are going to come from." Virtually all of the witnesses deplored the 25 percent funding cut including the National Governors Association and the NCSL which believe States could have absorbed up to a 10 percent cut. In addition, there was general agreement about the need for an orderly transition to the block grants. All witnesses agreed that a longer phase-in was essential and Stephen Farber summed up the feelings of many of the witnesses when he said, "Adequate transition language must be included . . . if block grant implementation is to be not a confused and damaging process but an orderly and effective one."

Unfortunately, this warning has not been heeded. The consolidation of 57 existing programs became effective on October 1, 1981. Criticism of the magnitude of both the numbers of programs consolidated and the funding cuts have been widespread. One Republican Senator charged, "This Administration is so busy balancing the budget that they haven't had time to think about policy." However, that may not be the case at all. The rapidity with which these proposals were prepared, the lack of communication with State and local officials, and the disproportionate funding cuts imposed on this sector suggest that there was, indeed, thought to policy—the policy being a termination of programs intended to benefit disadvantaged people and places.

We are not opposed to program consolidation of block grants as such. It is our opinion, however, that block grants are not suitable for all programs. The ACIR has pointed out, under certain conditions, block grants can lead to improved efficiency, greater decentralization, and increased coordination. The ACIR further urges, and the Democrats agree, that these grants should be used to consolidate similar programs to achieve national objectives, should involve recipient input, and should contribute to the alleviation of State and local problems. However, it is important to be aware of their strengths as well as their weaknesses. In some instances, categorical programs may work better, but may require some fine-tuning.

Revenue and Program Turnbacks

Above and beyond consolidating categorical programs, the President maintains that his ultimate goal is to turn the sources of revenue back to State and local governments.

The first indication of the course the Administration plans to pursue was revealed in the President's State of the Union message on January 26, 1982. The President outlined two major policy initiatives designed to significantly realign Federal-State-local relations. The basic features of the programs are as follows:

There would be a $50 billion transfer of Federal programs to States over an eight-year phased transition, with, we are told, equivalent revenue sources. The major components are:

> A "Swap Component"—Federal takeover of Medicaid in exchange for State takeover of Food Stamps and AFDC ($20 billion exchange). Under this plan, Medicaid would be fully Federalized in Fiscal Year 1984 and at that time States would assume full responsibility for AFDC and Food Stamps with "flexible" maintenance of benefits requirement for the State program.
>
> A"Turnback Component"—Approximately 43 Federal programs would be turned back to the States—the largest component being social, health, and nutrition services. A $28 billion trust fund would be established to finance these.

Phase one of the turnback would occur during Fiscal Years 1984 to 1987. During this time, trust fund allocations to States would be based on historic program shares from 1979 to 1981. State funds may be added to Federal grant programs which continue in their current form through Fiscal Year 1987 or as a no-strings super revenue sharing payment if the States opt out of the Federal programs early.

Phase two would occur in Fiscal Years 1988 to 1991. During this time, the grant programs would be terminated at the Federal level. The trust fund payments and Federal excise taxes would decline by 25 percent each year with States free to substitute their own taxes or reduce program costs.

Before these proposals are enacted, however, the following considerations must be carefully weighed and resolved.

Swap Component

Although the Administration has indicated that the dollar-for-dollar trade-off between Food Stamps and AFDC on the one hand and Medicaid on the other may balance in the aggregate, a recent analysis by CBO [15] concludes that, if the swap had occurred in FY 1981, the State sector would have lost $4.4 billion. On a State-by-State basis, it seems certain there will be some winners and many losers. The Southern States typically have lower Medicaid costs and also have contributed less for welfare payments, which were supplemented by the Federal Government. The Federal Government would now assume the Medicaid costs. However, since there will no longer be Federal supplementation of welfare or Food Stamps, States may have to increase expenditures for these purposes—particularly if there is a hold-harmless involved. It seems clear that recipients in Southern States are likely to derive higher benefits if Medicaid is nationalized, as benefits in these States are presently very low. The question remains, however, whether recipients in higher-benefit States would be penalized if a shift to Federal control of Medicaid were to occur.

In some States, the costs for welfare and Food Stamps may be less than the Medicaid amount being assumed by the Federal Government. However, many States are hard-pressed fiscally, and may find it politically attractive to trim these welfare programs; especially if no hold-harmless is required.

Many other States will be net losers. In Florida, for instance, the Federalization of Medicaid in fiscal year 1981 would have saved an estimated $221 million, but the assumption of Food Stamps and AFDC would have cost $770 million, for a net loss of $549 million.

If Food Stamp and AFDC standards are imposed by the Federal Government, they must be accompanied by sanctions for noncooperation (loss of funds, etc.). However, Federal standards of any sort fly in the face of the Administration's objectives of delegating these responsibilities to State and local officials. And since no Federal funds are involved, any sanctions may lack effectiveness.

If no Federal standards for AFDC and Food Stamps are imposed, presumably States would be free to determine benefit levels as well as eligibility requirements. This could result in tremendous divergence from one State to another, with the result that more benevolent States become attractive to those individuals able and willing to "vote with their feet." Thus, the lowest common denominator could prevail if States attempt to stay competitive and not become magnets for the Nation's poor.

Cities with chronically high unemployment rates tend to be fiscally strained. There is a correlation between large cities with fiscal problems and States with fiscal problems. Those States in which large fiscally stressed cities are located tend to have fiscal problems as well. These States tend to have large dependent populations and a large demand for AFDC and Food Stamps. However, they are least able to afford to establish new services. Even with the Medicaid tradeoff, States that are raising taxes and cutting services may find it fiscally or politically difficult to absorb new programs for the poor at anything but a minimal level. If there is a Federal minimum standard, this could well become the ceiling as well as the floor in many States.

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[15] Congressional Budget Office. *AFDC, Food Stamp and Medicaid Exchange.* Washington, D.C., January 29, 1982, p. 1.

Turnback Component

There are significant problems in turning the 43 categorical programs over to the States and paying for them (at least initially) with excise taxes. In the first place, unlike progressive Federal income taxes currently used to support these programs, excise taxes are regressive. Even if States chose to support such programs with other taxes, property and sales taxes and user charges are also regressive. Thus, these programs would be supported by disproportionately burdening the poor. Moreover, creating new or increasing existing taxes is very difficult on the State and local level; particularly if needed to support programs such as community development and social welfare, which do not benefit the community at large.

State legislatures are frequently regarded as less than fully responsive to the needs of poor people or minorities. In addition, many State Capitols are located outside of the major urban centers; not easily accessible to the poor. Also, sessions frequently are short, thus prohibiting extensive debate or opportunity for citizens to be heard. In other States, the Governor would have total control and discretion over how the funds are spent and which programs are to be continued (at least initially; if taxes are to be levied, the legislatures must be involved). However, some Governors are apt to make arbitrary decisions without consultation with local officials or interest groups.

In addition to these, there are a number of complicating factors. For instance, some governors, who might ordinarily support such proposals, would oppose any Federal requirements at all. If there are no Federal requirements, there will be a storm of protest from interest groups and other who feel that these are necessary to safeguard the welfare of the Nation's poor. However, establishing minimum requirements, in and of itself, will create problems because some States are bound to win and others to lose when this occurs.

Also, mayors and other local officials who presently receive Federal grants for such programs as community development, water and sewer programs, transportation programs, etc., Are not likely to support these programs becoming State block grants with the governors and/or State legislature having total discretion over which programs are continued and who will receive them.

Above and beyond these ideological and political considerations, there remain important questions about the cost estimates prepared by the Administration. The $30.2 billion estimated cost of the programs to be turned back understates the total current program funding by over $7 billion. Like the AFDC and Food Stamp costs estimated by the Administration, they are assuming new cuts will be passed by the Congress. State and local governments lost $12 to $15 billion in fiscal year 1982 Federal funds and the Administration is proposing an additional $7 billion cut in these 43 programs prior to fiscal year 1984. Above and beyond these, if the AFDC and Food Stamp cuts are not enacted, the States would lose $1 billion in the swap. Additionally, it has come out that the excise taxes, which are to comprise the trust fund, are also proposed to be reduced and therefore would fall short of the $28 billion being used for illustrative purposes. These facts were not immediately made available and their release was not initiated by the Administration. In dealing with such a complex, technical, and far-reaching proposal, it is absolutely essential that all data and information be straightforward and accurate. If the Administration is not prepared to assume this responsibility, then proposals of this magnitude ought not to receive the serious attention of Congress or other interested parties.

If a "New Federalism" is the order of the day, then our State and local governments and their residents are due, at the very least, a careful deliberation of the ramifications of the proposed actions, an opportunity to be heard, and a gradual transition to the new approach. To date, they have been afforded none of these rights.

The Bolling-Roth Bill

S. 10 and H.R. 18, the Bolling-Roth Bill, would create a Commission on More Effective Government. The Commission would take a sweeping look at the Federal system, particularly the Executive Branch, and would design a blueprint for improving governmental performance throughout the intergovernmental system. This would be a two and one-half year Commission costing $10 million. S. 10 passed the Senate on December 7, 1981, by a vote of 79-4. Its early enactment would help restore the right of State and local governments to a careful consideration of the intergovernmental system before irrevocable actions are taken.

F. FIGHTING INFLATION

Recommendation No. 26: A Cooperative Policy to Fight Inflation[16] [17]

> **In past years, we have consistently called for an incomes policy as a necessary component of a comprehensive strategy against inflation. This year, we repeat that recommendation. An incomes policy should take the form of a national bargain between government and labor, with business participation. Such a bargain must be founded on principles of fair treatment, and its details must be worked out in discussions between those who would be a party to it.**
>
> **Government should guarantee to labor that workers will not suffer unfairly as a consequence of good-faith cooperation in fighting inflation.**

As the economy pulls out of the current recession, we urge that a policy be developed to avoid a repeat of the wage-price spiral which so seriously impaired our ability to control inflation during the 1970's.

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[16] See footnote 3, part II.

[17] Representative Long states: I agree that exclusive reliance on restrictive monetary policy to fight inflation is extremely costly in terms of unemployment, lost opportunities and the longrun non-competitiveness of the American economy. There are alternatives. In my view, greater labor-management cooperation in the plant as well as at the industry level will help spur productivity as it moderates inflationary pressures. The Federal Government can play a supporting role in this process. A growth- and investment-oriented overall economic policy would create the climate in which private sector flexibility is likely to thrive. In addition, the government can use its good offices to help facilitate private sector initiatives originating with labor and management.

The Nation's economy has been pummeled by inflation for more than 15 years, and the vast majority of American businesses and consumers have come to expect it as a fact of life. Each sector of the economy has developed structural mechanisms that have helped it adapt to a climate of rising prices, but these structures in turn contribute to the momentum of inflation. Many labor contracts, for example, include cost-of-living adjustment clauses that compensate for all or part of the inflation-induced loss of real income. The fact that many major labor contracts are written for a three-year period locks in these cost-of-living adjustments even during deep recessions. To the extent that these increases are not offset by productivity improvements—especially elusive during a recession when output generally falls more rapidly than employment—they raise business costs and thus put upward pressure on prices.

The efforts of workers and businesses to adjust to continued inflationary expectations, and to stay even with or ahead of rising prices, thus contribute to the inflationary process and make it more difficult to slow the pace of inflation. Each round of wage increases in turn raises unit labor costs. These higher costs then result in higher prices, which form the basis for yet another round of wage demands. This generates a momentum in the information rate which tends to be very persistent and very difficult to reduce.

During the past decade and more, the United States has experimented with a variety of techniques to suppress wage and price increases—outright wage and price controls, Presidential jawboning, tight monetary policies, taxing and spending policies designed to slow economic growth, tax measures to boost productivity, and policies designed to induce recessions.

All of these techniques failed to provide permanent relief because we never developed a comprehensive anti-inflation program which included agreement on an equitable distribution of the burden of fighting inflation. Left to their own devices, business and labor sought instead to protect their real incomes by demanding ever-higher wages and prices, creating an inflationary momentum that could only be temporarily broken by recession and unemployment.

The present Administration has adopted a simple, traditional strategy—that of bludeoning labor into low wage settlements. HIgh interest rates and recession have destroyed the profitability of the basic industries up for contract renegotiation this year, especially automobiles, rubber, and trucking. High unemployment has brought home the threat remaining workers face directly and harshly. The result is indeed likely to be relatively low wage settlements this year and for as long as the recession and imminent threat of unemployment continue to hold workers in thrall.

This situation obviously cannot endure indefinitely. The American people will not long tolerate government policies which perpetuate unemployment, thwart their desires for improved wages and living standards, and cripple the trade union movement. Either this Administration will move sooner or later to foster economic recovery, or the voters will replace it with an Administration that will. And when that happens, the inflation genie will re-emerge from its bottle, as both business and labor strive to restore real living standards more rapidly than underlying economic improvements may permit.

For this reason, a durable anti-inflation strategy must be reconciled with economic growth. It must be a "supply-side" strategy: it cannot rely on periodic bouts of depressed demand to weaken tight labor markets, reduce farm, commodity, and housing prices, and soften inflationary expectations. Rather, it must be a strategy which guarantees a durable increase in the real standard of living, including the quality of worklife as well as private consumption, in return for nominal wage increases which are in keeping with the economy's real productivity growth and hence with rising real incomes and near-stable prices. This is an old objective, more often stated than achieved. The key to getting there, we believe, is a national bargain between government and labor, with business participation, which establishes common goals on the basis of common economic expectations and negotiated agreement regarding the pursuit of important political goals.

Very few other mature economies have been able to avoid the inflation and unemployment syndrome that has plagued the American economy. But where there have been successes, an incomes policy has generally been involved. Such a policy has typically meant, more than anything else, that a climate of trust and cooperation exists between a country's government and its working population. Trust makes possible negotiation, in which each side is willing to give up a little of what the other side wants most, and in which new international developments—such as rising oil prices, or shifting exchange rates—can be jointly analyzed and rapidly adjusted to. Trust, negotiation, shared responsibility, and coordinated behavior seem to underlie the relatively successful performances of Germany, Japan, and Austria, and form more of a common link between the systems of those countries than any specific institutional mechanism provides.

During the past year, the Joint Economic Committee heard testimony concerning the contribution which a widely supported incomes policy can make to fight against inflation. Our hearings included an historic appearance by Austrian Finance Minister Hans Seidel on June 2, 1981, the first member of a foreign government to appear before the Joint Economic Committee.

Austria provides a case of a successful incomes policy based on a national bargaining process. During the 1970's, while unemployment in the United States ranged as high as 9 percent and inflation reached over 13 percent, Austria—whose economy was buffeted by the same ill winds as our own—kept unemployment below 2 percent while bringing inflation down from 10 percent in 1975 to less than 4 percent in 1978 and 1979. In addition, the economy of Austria was virtually free of strikes and enjoyed a period of almost unparalleled social peace.

This was largely achieved through an incomes policy, according to Austrian Ambassador Karl Schober, who testified:

> The explanation for this Austrian miracle, as it is sometimes called, lies in a well-functioning mechanism for dis-

> cussion and settlement of basic economic and social issues. This mechanism, called the Commisson of Parity, provides for an institutionalized and continuous dialog between all the economic forces of labor and commerce on a decision-making level. The role and the effective representation of those forces as well as our government in this mechanism go a long way to assure that compromise is always found and that strikes are practically eliminated from our economic life.

The Austrian system was described for the Committee by Finance Minister Seidel:

> Perhaps the best way to begin a description of the Austrian version is to explain what it is not. (a) Incomes policy in Austria is not a short-term device to overcome temporary difficulties. We do not switch between policy-on and policy-off periods. Instead, incomes policy is regarded as a permanent task with long-term consequences. (b) Incomes policy in Austria does not use mandatory controls, government intervention is kept to a minimum. Only in the immediate post-war period did price fixing play an important role. (c) There are no explicit (openly announced) quantitative wage guidelines, although there is a widespread understanding in which wage increases seem to be consistent with a sound economic development and that the claims of individual unions should stay in line. (d) Incomes policy in Austria is not required as an instrument for changing the personal or functional distribution of incomes. It is based on the idea of approximate constant shares of labor and capital in the national income.
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> I think incomes policy in Austria has to be regarded as an essential part of the broader concept of what we call "Social Partnership," a durable cooperation between the representatives of labor, business, and agriculture.
>
> The institutional framework at first might seem to be rather complicated, but it has developed on the idea of a social contract along the following lines: the trade unions are willing to abstain from using their full bargaining power in wage settlements if they get something for it. Especially, they want to have some influence on the formation of prices for products in oligopolist markets, and they want to participate in decisions on general economic policy.
>
> Social partnership, according to my view, not only means that we all sit in the same boat; it also means that we are willing to steer the boat in a direction upon which most of us agree.

The success of the Austrian incomes policy was described by Foreign Minister Seidel at the conclusion of his testimony:

> First, there are almost no strikes in Austria. We are, so to speak, on the bottom of the international strike league. The disruption of production associated with long-lasting conflicts in the labor market has been avoided.

> Second, during the stormy seventies, the overall performance of the Austrian economy was quite satisfactory. The annual growth rate on average was 1 percent higher than in the whole OECD area; inflation was lower than in the other industrial countries; and unemployment kept at low levels.
>
> The most remarkable development in the seventies in the context of this hearing, and of my argument, was the rapid decline of inflation after the first oil price shock. In 1975, we had an inflation rate of nearly 10 percent, but this rate was reduced to 3.5 percent in the years 1978 and 1979 without creating unemployment on even a temporary basis.
>
> These and other observations are clearly not sufficient alone as evidence for the effectiveness of incomes policy in Austria. Other factors surely have to be computed into the so-called success story of Austria. Nevertheless, most economists who have analyzed the Austrian case have argued that incomes policy in Austria has been reasonably successful.

In both Sweden and Norway, according to other witnesses who testified at a hearing on Scandinavian Incomes Policies on October 20, 1981, incomes policies also succeeded in holding wages and prices in check during the 1970's, although government policy mistakes and strong external shocks undermined the effectiveness of these efforts toward the end of the decade.

A national bargain underlying a successful cooperative incomes policy in the United States could be designed as follows:

> (1) Government would make a formal commitment to a range of policies which are in the national interest and in the interest of working men and women, both union and nonunion. These policies include fair tax policy, vigorous pursuit of occupational safety and health objectives, enforcement of antidiscrimination statutes, and support for fair labor practices and for the objective of enhancing job security through the collective bargaining process.
>
> (2) Organized labor would agree to the pursuit of moderate wage claims, and so set a national climate for average wage settlements that is compatible with decelerating inflation. Such a climate can emerge from annual discussions between labor and government, with business participation, in light of economic conditions prevailing at the beginning of each year.
>
> Over time, an evolution of collective bargaining calendars toward annual, coordinated negotiations would facilitate adjustment and reduce inflationary inertia.
>
> (3) Finally, government would guarantee to labor that workers would not suffer unfairly as a consequence of good-faith cooperation in fighting inflation.

The measures we have recommended elsewhere in this chapter will help stabilize prices in the long run by reducing costs, increasing productivity, and by cutting the momentum of the underlying rate of inflation. While they should be implemented as soon as possible, we can expect them to have little short-term effect.

During the transition period—while the economy is recovering from the recession and we are progressing toward necessary long-run changes in the structure of the American economy—the ingrained expectation that inflation will reaccelerate must be broken. Otherwise, business and labor will make wage and price decision in anticipation of renewed inflation that will only serve to generate the very inflation we all hope to avoid.

In order to end our unfortunate dependence on recessions to control inflation, Congress must cooperate with the President to develop a full range of policy options for dealing with rising inflationary expectations. Enactment of mandatory measures, however, should be contingent upon the introduction by the President of a comprehensive and productivity-enhancing anti-inflation program.

Recommendation No. 27: Promote Energy Security

> **We must continue to promote energy conservation; therefore we oppose the reallocation of Energy Department resources from conservation which the Administration has effected. Enhanced development of coal is vital, as discussed elsewhere in this Report. In addition, we should encourage development of improved techniques for enhanced oil and unconventional gas recovery, and continue to fill the Strategic Petroleum Reserve at a satisfactory rate. These measures would work to reduce the sensitivity of U.S. energy supply and price to external shocks.**

The security of U.S. energy supplies increased in 1981 as the flow of imported energy fell to the lowest level in almost a decade. In 1981, imported energy met only 19 percent of total U.S. energy demand, down from 26.3 percent in 1977.

Our reduced energy dependence reflects the impact of reduced demand for petroleum as a result of the broad recession, continued conservation progress, and maintenance of domestic oil and natural gas production. The staggering economy pushed the consumption of petroleum products, including natural gas plant liquids, down some 7 percent in 1981, for the third consecutive annual decline. Total domestic energy consumption per (constant) GNP dollar fell over 4 percent during the first three quarters of 1981 compared to the year-earlier period. The United States utilized energy more efficiently in 1981 than at any time in recent history.

The complete decontrol of oil prices in early 1981 stabilized domestic crude production at close to the 1980 level of 18.6 million barrels a day, including Alaskan production. Robust domestic petroleum prospects are also reflected in record rates of exploration. Rotary rigs in operation and the number of exploratory and development oil wells drilled set new records last year. Natural gas production was robust in 1981, as well, with output slightly exceeding the 1980 level despite a decline in consumption. While natural gas imports declined 10 percent, the stock of working gas in underground storage reservoirs at the end of October and available for withdrawal was at record levels.

The continued reduction in U.S. energy dependence in 1981 is partly obscured by demands placed on imports used to fill the Strategic Petroleum Reserve. An average 334,000 barrels of oil daily were pumped into the SPR in 1981, six times the rate attained in 1980. At the end of 1981, the SPR contained oil comparable to imports received during a 40-day period at the import rate achieved in 1981. Private primary crude oil stocks exceeded 350 million barrels at the turn of the year. Consequently, total domestic oil reserves in the absence of other energy demand and supply actions are now comparable to three months' imports.

The United States enjoys a greater degree of energy security today than at any time since 1973. This degree of security is still not fully adequate, however. While domestic oil stocks and energy production are high, nearly one in five units of energy consumed domestically in 1981 came from abroad.

Our Nation's improved ability to minimize the impact of relatively short energy import disruptions has not resolved our excessive level of energy dependence. We still rely too heavily on insecure foreign energy supplies. The stability of world oil and energy prices is tenuous, as well, and is solely the result of continued high production by Saudi Arabia. In addition to the continued filling of the SPR, a variety of other steps should be taken to increase our Nation's energy security.

For several years, the Committee has argued for Federal efforts to promote the use of enhanced oil recovery technology. Primary and secondary oil extraction techniques typically capture less than 30 percent of oil from reservoirs. From 7 to 8 percent more of that oil can be extracted with a variety of enhanced recovery techniques, including gas and steam injections and more exotic chemical application.

As the Committee stated in 1980:

> Federal research into enhanced recovery technologies should be accelerated now if this promising supply option is to contribute notably to the domestic energy stock during the 1980's.

In 1980 and 1981, a variety of promising unconventional Federal energy research options was evaluated on behalf of the Committee by the Congressional Research Service. The 18-month long analysis by over 15 experts was completed and released in early May 1981. Thirty-one unconventional near-term energy supply options were evaluated. The most cost-effective and promising unconventional sources of additional energy through the year 2000 identified were heavy oil, which is too thick for extraction with existing technology, and unconventional natural gas trapped in coal, sandstone, and shale rock.

The analysis noted that limited Federal R&D support of heavy oil extraction technologies could result in a doubling of heavy oil production by 1990 to one million barrels daily. Similar limited Federal support for research into unconventional gas technologies could increase U.S. domestic natural gas production by up to 45 percent by 1990.

To the extent Federal funds are available for unconventional energy supply R&D, the refinement of technologies to extract heavy oils and unconventional natural gas should be priorities.

The Committee continues to believe that energy conservation and the use of renewable energy alternatives is a necessary component of a comprehensive national program to improve our energy security. Substantial investment has occurred as a consequence of tax incentives for industrial and residential conservation and the installation of solar energy equipment. The continuation of these fiscal incentives is appropriate to ensure that reliance on imported energy sources continues to decline.

Further gains in our Nation's energy security can be realized from continued research into energy conservation and the renewable energy technologies. In Fiscal year 1980, Federal research, development, and demonstration budget authority for these programs totaled $1.5 billion, and comprised almost 11 percent of the Department of Energy's budget. Private conservation efforts have continued to blossom and renewable energy technologies mature. Yet, Administration budget requests for these programs in the current fiscal year were reduced percipitously to less than $400 million, only 3 percent of DOE's budget. Administration plans for Fiscal Year 1983 call for a further reduction in Federal support for these programs to $22 million (conservation) and $73 million (solar).

A continued viable Federal program of research on energy conservation, renewable energy, and coal technologies is a necessary component of a broad-based national program to improve our energy security. While we support efforts to eliminate waste and fraud and reduce government spending, such motives should not provide an excuse to eliminate support for conservation, renewable energy, and coal research.

Recommendation No. 28: Maintain Agricultural Stockpiles

> **The bumper grain crop of 1981 and large carry-over stocks provide an opportunity for action to expand our program of grain reserves and to ensure stable prices for consumers and stable incomes for farmers in future years. The Department of Agriculture should be directed by the President to develop a proposal for maintaining national grain stockpiles at adequate levels. Sharp fluctuations in our food supplies could be reduced by pursuing a renewed bilateral purchase agreement with the Soviet Union.**

The grain and rice reserve program has as one of its goals to stabilize prices for agricultural products. This is desirable for the consumer, because inflation in the agriculture sector puts inflationary pressure on the economy as a whole, and for the farmer because an adequate reserve protects him against devastating swings in supply (for example, due to weather) or in demand (due to the high variability of world demand for U.S. food exports).

The farmer-held grain reserve program for wheat, corn, barley, sorghum, and oats is the largest part of current reserves; this program was established by the Food and Agriculture Act of 1977. Through this program, farmers are encouraged to store designated commodities when stocks are higher to than needed to meet domestic and export requirements, and to release these stocks to the market when demand and prices are high. Currently, grain carry-over stocks are enormous. As of the end of October, the total stock of wheat in the United States was 24.7 million metric tons, of which 12.9 million was farmer-owned. Feed grain carry-over was 49.8 million, making a total grain reserve of 77.2 million metric tons.

Grain reserves of this volume can put a strain on the system, particularly in times of high interest rates and hence high carrying costs. At the same time, the existence of ample reserves provides an opportunity to buffer the economy against the resurgence of agricultural price inflation in the future, while simultaneously boosting depressed farm income.

We urge that the Department of Agriculture explore the possibility of enlarged national grain reserves to ease the burden on farmers of the present system and help assure stable prices to consumers in future years.

It is disappointing that the Administration chose to include among the "sanctions" imposed on the Soviet Union after the Polish crisis a decision to defer renegotiation of the long-term grain purchase agreement which had been in effect since October 1, 1976. While we sympathize with the Administration's expressed motives, it should be remembered that this agreement served primarily to assure a stable and predictable Soviet demand for our grains, and to avoid a repeat of the "Great Grain Robbery" of 1972, during which massive and unexpected Soviet purchases drove up U.S. grain prices and added sharply to domestic inflation. The long-term grain agreement was thus more of a protection for consumers in the United States than for the Soviet Union. We urge the Administration to move to the necessary process of negotiating renewal of that agreement as soon as the international political climate allows.

Recommendation No. 29: Promote Competition, Not Cartels [18]

> **The Reagan Administration has retreated from progress toward free competition in several vital transportation sectors.**
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> **The Interstate Commerce Commission, under Chairman Reese Taylor, has moved abruptly and dramatically to reinstall cartel-like restrictions on the trucking industry, to the detriment of independent truckers, shippers, and consumers. The President should give explicit guidance to the Interstate Commerce Commission that it return to a policy of free entry, free price-setting, and free competition in the trucking industry, consistent with the deregulation purposes of the Motor Carrier Act of 1980, and should take all necessary steps to ensure the installation of a pro-market majority on the Commission.**
>
> **In the case of airlines, the Administration has also compromised the principles of free competition. International air carriers have been permitted to resume price-fixing negotiations at the International Air Transport Association, and domestic carriers have seen severe new re-**

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[18] Senator Sarbanes expresses concern about certain deregulation procedures which may in fact not serve the public interest.

strictions on free entry in the domestic market for air routes. The Administration should move promptly to reassert the rule of the market in air transport.

In antitrust enforcement, the Administration has adopted a "bigger is beautiful" attitude which has encouraged marriages of the giants, further reducing the scope of competition in the economy, and exacerbating the diversion of scarce capital resources away from longer-term, productive investment.

The Committee has consistently argued in past years for a reduction in unnecessary regulation and for the selection of the most cost-effective methods to reach legislated regulatory goals. This Administration came to office pledged to a platform of free competition and deregulation. Since January, the Administration has moved aggressively to reduce regulatory bureaucracies throughout the government to the point where questions may be raised whether it has gone beyond the mere promotion of efficient performance, and begun to hamper effective enforcement of environmental, safety, health, antidiscrimination, fair labor practice, and other legislated national objectives.

In the area of transportation, however, the Administration has reversed the progress toward free competition which had been made in previous years. The reversal is most egregious in the case of Interstate Commerce Commission regulation of the interstate trucking industry, as the Committee was told by a bipartisan panel of witnesses at a hearing on November 13, 1981. The ICC, under President Reagan's newly appointed Chairman, Reese Taylor, has turned back the clock, back to the days when the Commission served the price-fixing and entry/retarding interests of the large truckers rathr than that of the public at large. This reassertion of special interest against the general welfare should be reversed at once.

In the 16 months immediately following passage of the Motor Carrier Act, motor carriers displayed a new willingness to offer cost-related discounts on freight rates. Both carriers and shippers moved aggressively to explore new business opportunities. Service availability to cities and towns remained at least as good as before; and, in some instances, service improved. Operating authorities applied for by truckers were broadened, giving them permission to haul more commodities to and from more places. New entry was eased, as was the setting of rates and tariffs.

Under the Chairman appointed by President Reagan, Reese Taylor, voting patterns of the Commission began to change. Evidence presented before the Committee at the hearing in November indicated what one panelist, Alfred Kahn, described as a "clear retreat from free market principles." Former Commissioner Marcus Alexis was more direct. He charged before the Committee that, "In a series of decisions, the Commission has embarked on a deliberate, calculated policy to reimpose restrictive, burdensome, inefficient, inflationary-prone, and fuel-wasting regulation on the trucking industry."

Tariff filings, it was noted, are reviewed more closely than before, even in the absence of complaints. Price discounts are being disallowed on the grounds that they are "predatory" or "discriminatory." The ICC has sought a larger enforcement budget even at a time when the Administration has announced its intent to reduce enforcement at other regulatory agencies (the Food and Drug Administration, the Federal Trade Commission, the Occupational Health and Safety Administration, the Consumer Product Safety Commission, the Environmental Protection Agency, and others). Oral hearings are being required more frequently than before despite their expense to shippers and the chilling effect they have on applicants seeking new or expanded operating authority. The ICC is granting new operating authorities in much narrower terms than previously. More restrictive tests of fitness for operating authority are being proposed.

The restrictive interpretation of the Motor Carrier Act of 1980 now being applied at the ICC is contrary to the intent of Congress, economically unsound, and also conflicts with the 1980 campaign position of candidate Ronald Reagan, who said "our objective will be to deregulate and revitalize the entire transportation industry—rail, highway, and water—to reduce waste. . . ." We have urged in a bipartisan report that the President renew his Administration's originally stated position on trucking regulation, and, if necessary, help to reorient ICC policies by nominating Commissioners of more appropriate views to vacant Commission seats.

The trucking industry as regulated by the Interstate Commerce Commission is a national giant. It generates $43 billion a year in revenue, employs nearly one million people, and pervades our national economic life. Restoring competition in the industry is important not only for the sake of theoretical principles of the free market, but also for purposes of fighting excessive dependence on overseas oil, and market efficiency. In an Administration known for its otherwise zealous determination to deregulate, the case of the trucking industry stands as a glaring omission.

In other parts of the transportation industry, progress toward deregulation and free markets has likewise been impeded under the new Administration. The Interstate Commerce Commission has resumed strict tariff examinations for rail freight operations, which discourages the railroads from effective price competition with each other or, perhaps more important, with the trucking industry. The effect of this is anticompetitive, and carries no corresponding short- or long-run benefits for the general public.

In the case of international air transport, particularly with respect to the North Atlantic traffic, the Administration appears to have retreated from the determination of the previous Administration to bring about an era of free and competitive pricing. On June 9, 1978, the Carter Administration canceled the antitrust immunity for air carriers which had previously permitted them to fix prices under the auspices of the International Air Transport Association (IATA). The effect was to unleash a wave of competitive pricing behavior so that North Atlantic air travel prices today are lower in nominal dollars than they were in 1975, with enormous benefits to Americans seeking to travel overseas and to the national efforts against inflation.

The Reagan Administration has repeatedly refused to enforce the Carter Administration's anti-price fixing efforts, with the result that U.S. air carriers have now returned to IATA price-fixing forum. The effect will be higher prices and less scope for free competition. According to an article in the February 1, 1982, issue of Forbes, the air fare in economy class for North Atlantic travel may rise as much as 15 percent this spring as a result of such renewed price fixing.

In our view, the market remains the best solution for air travel. We see no reason to allow price fixing in this market simply to allow airlines to underwrite the cost of massive excess capacity on North Atlantic routes. The correct solution to excess capacity and high costs is to reorganize service, not to perpetuate inefficient behavior. Subsidization by other nations of their own national airlines should be a matter for trade negotiations, but should not encourage us to emulate their wasteful example. The Reagan Administration should not further extend the deadline for the airlines to show cause why they should not be prosecuted under our antitrust laws for participating in international air traffic price fixing.

The case of domestic air travel is less clear-cut. The air traffic controllers' strike and the Administration's response to it clearly forced a reduction in total commercial passenger flights. The Federal Aviation Administration (FAA) has administered that reduction in an inflexible way so that free entry into specific markets, which was the mainstay of airline deregulation, has been brought to a virtual halt. It certainly is time that the FAA revised its air traffic restrictions to restore more flexibility to airline markets.

We attach enormous importance to rapid and thorough deregulation of our Nation's transportation industries, for two reasons. First, such deregulation sacrifices no benefits—the evidence clearly shows that the Nation will be better off under free price and entry competition in trucking, rail, and airline service than under heavy-handed government regulation. Second, the regulation of our transportation sector is immensely costly. According to a study prepared in 1978, regulation by the Interstate Commerce Commission alone imposes a larger cost on the economy than any other form of regulation: more than all environmental regulation, more than all safety and health regulation, more than all energy regulation, more than all consumer regulation. The author of the study was Dr. Murray Weidenbaum, currently Chairman of the President's Council of Economic Advisers.

Recommendation No 30: Productivity: The Private Sector Must Lead

The lead role in improving productivity must be assumed by the private sector. American business can and must take the lead in designing more efficient production processes, selecting and purchasing the most efficient equipment, and developing better worker-management relations and quality control.

We also reaffirm our support of the role government must play in promoting a higher rate of productivity growth. The role includes:

Economic policies which pursue economic growth, reduced inflation, full employment, and lower interest rates:

Tax incentives for saving, investment, and productivity growth;

Improved investment in public and private infrastructure;

Reduced anticompetitive economic regulation and Federal paperwork, cost-effective social regulation, and improved productivity in the Federal Government itself.

Faster productivity growth would make the most durable contribution to reduced inflation during a future period of economic growth. High productivity growth helps keep inflation under control by reducing unit costs. In addition, high productivity growth helps make American industry more competitive relative to that in the rest of the world.

During the past decade, our record of productivity growth has been dismal. Since 1973, output per hour in the private business sector has grown an average of less than 1 percent per year, a third of the 2.8 percent yearly increase registered between 1950 and 1973. Since 1977, productivity has risen barely one-tenth of 1 percent per year. Wage gains over the decade have been more than offset, as a result, by price increases and the real income of the average American worker today is actually lower than it was in 1973.

In part, our poor productivity performance can be explained by our poor economic growth performance. Productivity is highly sensitive to the business cycle; in particular, it falls rapidly during a recession. If, as has happened in 1980 and 1981, two recessions succeed each other with a short interval, the average productivity gain one might otherwise expect will not occur. And if productivity falls by more than money wages in a recession, as has happened, unit labor costs will rise and the expected gains against inflation will not occur during the recession either.

The Committee lays great emphasis on achieving a faster growth rate of productivity. During 1981, we issued a Midyear Report on Productivity containing nine recommendations to improve productivity, which were agreed to unanimously by the Democratic and Republican members of the Committee. In light of the close relationship between productivity growth, inflation, high interest rates, and recession, we continue to emphasize the need to improve our productivity growth.

The Federal Government can create an economic climate that is conducive to productivity growth by adopting the recommendations that we have made elsewhere in this Report. Monetary and fiscal policies should be coordinated to assure lower interest rates and economic growth, corporate tax provisions should be rewritten to assure efficient investment, spending for human capital formation should be maintained, urban and rural infrastructures should be overhauled, and an industrial development policy should be developed to help sustain the international competitiveness of American industry. In the short run, a return of economic growth would cause a significant and needed cyclical increase in productivity growth. All of these actions will help direct our economy toward higher productivity and lower inflation.

But the private sector can and must act on its own if we are to make permanent gains in productivity. American business management should begin focusing internal corporate policies on productivity, by balancing their short-term goal of higher profits with a new emphasis on such long-run strategies as developing new products, creating new markets and technologies, enhancing the quality of their products, upgrading the skills and training of production workers, and looking to their long-run survival in an increasingly competitive world economy.

According to Professors Robert Hayes and William Abernathy of the Harvard Business School, who testified before the Committee on May 1, 1981, corporate management today focuses too heavily on improving annual, and even quarterly profits, at the expense of investments that would enhance long-term productivity and competitiveness.

Professor Hayes testified:

> Managers in Europe and Japan hold different assumptions, display different attitudes, and follow different practices than U.S. managers. Moreover, they're becoming more and more critical of U.S. managers, whereas a decade ago they regarded U.S. management practices with great respect.
>
> Second, there's evidence that U.S. management practices and attitudes have undergone a profound change in the last 30 years. Japanese and European businessmen almost invariably refer to what we call modern management theories, or modern management practices, as modern U.S. management theories and modern U.S. management practices, and differentiate those very much from their own attitudes and practices.
>
> Third, there are theoretical bases for arguing that these new U.S. management practices might be expected to cause many of the problems that we are seeing.
>
> For example, our performance measurement systems, compensation practices, and the promotion expectations that have developed in this country over the last 30 years all tend to encourage short-term biases on the part of American businessmen.
>
> Second, the organizational designs that we have adopted and the marketing orientation of American companies encourage a reduced emphasis on technological competition.
>
> And third, the backgrounds of U.S. businessmen, their modes of training, their orientation, and the increasing diversification of large U.S. companies tend to encourage detached, analytical, and often superficial management understanding of the businesses they are entrusted to manage.

In short, there is reason to fear that American managers have abdicated their strategic responsibilities by foreswearing long-term technological superiority as a competitive weapon in favor of maximizing short-term financial returns.

This new management orthodoxy involves three aspects of corporate behavior. First, as companies grow and decentralize, they tend to look at profit centers as the primary unit of managerial responsibility, emphasizing short-term financial measures like return on investment for evaluating the performance of individuals and management groups. In this environment, a short-term drop in profits is a sign of failure even if it is the result of actions that would enhance the company's long-run competitiveness and productivity. Second, managers increasingly have viewed diverse businesses as portfolios, in which a remote group of dispassionate experts lacking technical experience allocate resources among different profit centers on the basis of portfolio theory. This leads to management which is overly cautious and too often unwilling to assume even reasonable risks. Finally, business managers have recently paid too much attention to producing only what is currently marketable, rather than risking the great technological leaps that will produce superior products in the future.

The result is too many American businesses that give us imitative rather than innovative product design, a reliance on outside capital goods producers to develop new technologies rather than on in-house equipment design and development, and an emphasis on merging with other companies as a way of surviving the vicissitudes of competition rather than on developing superior products at lower cost.

Some of the business emphasis on short-term returns is due to inflation and the structure of the tax code. This can be alleviated by appropriate government actions. But business must bear much of the responsibility for making necessary changes. As Professor Hayes testified:

> Now, our intent in this presentation is not to put all the blame for our current problems on the backs of U.S. managers, but is to emphasize that they share in the blame, and they must share in the solution.
>
> Our problems will not go away if the government gets off their back, or if OPEC gets off their back, or if organized labor gets off their back, or inflation goes away. The problem is a systemic one. And we are all, in some measure, responsible for it.
>
> We cannot guarantee, therefore, that government measures will, by themselves, encourage U.S. businesses to change their behavior. U.S. businessmen must themselves want to change. We are heartened by the evidence that there are a number of U.S. companies who have either begun to change from or have never changed to, some of these modern practices that we are concerned about.

What should be done by American industry to enchance productivity? The business practices of foreign industry, particularly the Japanese, as well as the practices of successful American firms can provide some direction.

The highest growth rate for productivity during recent decades has been achieved by Japanese industry. According to witnesses who appeared before the Committee in 1981, productivity growth has been a direct result of the Japanese emphasis on product quality. Within the Japanese system, quality means more than just having a low product rejection rate. Quality involves the whole approach to the production process. This includes preplanning for quality during the product design stage, training workers to have more pride in their work, developing an environment in which everyone is encouraged to expose quality problems and work to correct them, and checking all materials entering the production process for defects. Emphasizing quality also enhances productivity because, as Professor Abernathy points out, "When you get it right the first time, you don't have to fix it."

The Japanese emphasis on quality is already being adopted by some American companies. The Public Systems Company of Westinghouse Electric ". . . made an emphasis on quality throughout our entire production process one of our key strategies for productivity improvement," according to testimony by its president, Thomas J. Murrin, on June 1, 1981.

In a similar vein, the Motorola Company said in a statement submitted to the Committee:

> The classic definition of productivity is output per manhour. We firmly believe that a high quality product or service is a greater output than a poor quality product or service. In addition, by building a quality product, we avoid the wasted manhours required to repair faulty products and eliminate the manhours of labor that wind up in the scrap barrel in many factories.

We encourage other American companies to review their company policies toward product quality and the acceptable level of rejects, with a view toward adopting the Japanese policy of zero defects. The contribution to productivity can be significant.

Participatory management is another successful Japanese technique for improving productivity which is being adopted by American firms. Recognizing that no one knows as much about a job—and how to improve it—as the person who performs it, many firms have begun including production workers in business decisions through Quality Circles. By having workers define the problems they encounter on the assembly line or in their jobs and then develop their own solutions, firms that use Quality Circles have found numerous ways to increase productivity. For example, at Honeywell, 11 Quality Circles at one plant implemented solutions to 109 production problems, reducing assembly costs by 36 percent. Westinghouse has over 700 Quality Circles in over 150 plants, involving over 10,000 people.

There are numerous other ways in which businesses can generate employee enthusiasm for improving productivity. Sony Corporation of America, for example, attributes its success in achieving high quality and productivity to the special relationship Sony's management develops with its employees, as well as to the fact that Sony does not lay off employees during business downtowns. According to testimony presented to the Committee on May 1, 1981, by Sony's Assistant Vice President, Chris Wada:

> You can raise capital for your machines, automated robots, computer-controlled robots. You can have technology. You can have all the schematics you want. But without dedication of the people, you will not have quality nor

> productivity, and you cannot buy dedication from people. That is something we have to earn. . . . We believe we must have common goals and common pride between management and employees. Once you have dedication of your employees, they will help you solve problems. They will find for you more efficient manufacturing methods. They will cut out waste to maximize output.

According to Dr. James Renier, President of Control Systems, Honeywell tries to achieve the same results by recognizing that corporate goals must contribute to employee self-esteem. According to testimony by Renier:

> As part of our continuing work in this area, we are conducting research to assess the relationship of attitudes to productivity. Preliminary findings suggest a postive correlation between high performance, i.e., productivity, and the sense of personal accomplishment. Conversely, departments with lower performing workers were also those with negative perceptions of their work climate—that is where they felt they were treated like "kids," where they saw management as having a "blaming" attidude and where managers were not seen to be helpful in problem solving.

Other witnesses told the Committee of more traditional ways in which their companies are enhancing productivity. Robert Lynas, a group Vice President testifying for TRW, emphasized the need to engineer quality into products while they are being designed, by upgrading the "critical areas of quality and plant engineering" where the "Japanese are strategically out-engineering us." The Millipore Corporation, according to testimony on May 11, 1981, of its Chairman Dimitri D'Arbeloff, takes the view "that we must buck the tide, take the long-run view, make research and development expenditures in order to continue to grow and serve our customers here and around the world." Motorola establishes standards of performance for its production teams and then pays a monthly bonus proportional to the savings realized by the team.

While there are a wide variety of ways in which American business firms are trying to improve productivity, the critical element for success seems to be a commitment by top management to increase productivity, improving product quality, and upgrading the role of production workers in the decisionmaking process. The successes of the companies whose representatives testified before the Joint Economic Committee in 1981 indicates that there is much that American business can do to improve their own productivity, regardless of what the government does to help.

We urge each and every American business firm to develop its own productivity improvement program, as part of the solution to the Nation's productivity problems.

G. International Economic Policy

Recommendation No. 31: Trade

The Administration's policy of tight money and high interest rates has led to an overvalued dollar, which has

hurt U.S. exports, helped produce a sharp drop in our trade balance, and added to protectionist pressures.

The United States should press harder for more open international markets by accelerating the reduction in barriers to trade in high technology goods, pushing for international agreements on trade in international services, and reducing existing barriers to foreign direct investment. The United States should resist the temptation to transfer recession-bred unemployment to our trading partners with unfair trade restrictions. The United States should continue to facilitate the growth of U.S. exports, recognizing that the greatest progress in this area will come from a shift in economic policy fundamentals which encourages lower interest rates, worldwide economic growth, and a less overvalued dollar.

The United States confronts many challenges in shaping an international trade and investment strategy for the 1980's. The United States is still the driving force behind the liberal trading order. If barriers to trade and investment are to be eliminated in the future, it will still require American initiative and leadership.

Early U.S. leadership in designing the post-World War II economic institutions reflected the strong American military and political position at the close of the War. But America's economic leadership has also depended on the strength and dynamism of the American economy. The maintenance of a strong domestic economy depends principally on the right combination of fiscal and monetary policies, adequate public-sector investment in industrial infrastructure, research and education, and the presence of an aggressive, risk-taking private sector. In the case of the United States, spurring domestic economic growth will also require a definite shift in trade policy.

Going forward with the liberal trading order will be difficult because of growing pressures to go backward. As Europe and Japan have regained their standing as sophisticated industrial competitors and the developing world has begun to challenge our primacy in many markets, more and more U.S. industries face serious import competition. As a result, Congress and the Executive Branch can be expected to feel greater and greater pressure to slow the process of trade liberalization. In many cases, industries will seek temporary relief from import competition or perhaps even more comprehensive protection modeled on the the support currently given to the textile and apparel industries. The pressure for domestic protection of new industries is likely to grow as more of America's competitors seek to enter the high technology fields of computers, semiconductors, telecommunications, bioengineering, and mineral exploration—especially off-shore drilling.

Keeping Foreign Markets Open

The latest Tokyo round of trade negotiations continued the process of liberalizing trade in manufactures among the industrial democracies.

Many barriers to trade, however, still play a role in determining trade flows. The remaining trade barriers hit particularly hard at two major areas of U.S. export strength—agriculture and high technology goods. Europe, Japan, and a number of developing countries are intent on moving into a range of high technology industries that had long been dominated by the United States. Japan has already made substantial strides in closing the gap in a variety of electronic products and actually opened a gap of its own in the sale of the 64K Ram semiconductor and the development (announced by Hitachi in February 1982) of the 256K Ram.

In attempting to develop high technology industries, America's competitors have adopted a wide range of policies, including the closing of the domestic market to foreign competition. In its search for greater balance in an expanded liberal trading community, the United States must forcefully move to open foreign markets to its current high technology strengths.

The Tokyo round of trade negotiations did make a little headway in the high technology area. For instance, tariff reductions on some high technology goods were included in the overall package of tariff cuts.

In a recent initiative, the Administration reached an agreement with Japan to accelerate the reduction in tariffs on semiconductors that had already been negotiated as part of the Tokyo round. The Administration has also continued to monitor the commitment of Nippon Telegraph and Telephone to open up its bids to American competition. We need a great deal more of the same. The initiative announced by Japan in January to further reduce nontariff barriers indicates a welcome awareness on their part of the problems. Although neither we nor the Administration believe that bilateral trade balance with Japan is necessary or desirable, further progress in opening Japanese markets to U.S. exports will have highly beneficial effects, politically as well as economically.

The United States has a vital stake in the continued growth of its high technology industries. There is a growing concern in the United States that the American system of open markets and private enterprise will not be able to compete with the relatively closed markets and sophisticated industrial policies found in some of our major competitors. Some industry specialists are already suggesting that the United States will have to close its markets to maintain our high technology lead. It will be doubly difficult to resist such pressures from high technology industries without a firm commitment to opening high technology markets overseas.

There were also important questions that were not touched on at Tokyo round. The growing trade in international services and the links between foreign direct investment and import penetration may require the development of new international rules.

International commerce in services has become an important element for a variety of American businesses. Insurance, banking, engineering, accounting, management consulting, construction, and many other services are now provided by American-based companies to a large number of foreign countries. The sale of international services often complements the sale of American exports or the overseas presence of American manufacturing enterprises. In addition, the revenue from services makes a substantial and positive contribution to America's international payments position.

The question of international services is not confined to the United States. European, and more recently Japanese, firms are now competing in a wide variety of services. The developing countries also have a growing stake in open markets for international services. For instance, Korean and Brazilian construction firms have been active and successful in the Middle East.

The continued growth of the multinational corporation, the closer travel and communications links among countries, and the steady increase in world economic interdependence all point to a rapid growth in internationally traded services. At the same time, the lack of general rules governing trade in services could lead to competition among nations that would be extremely disruptive. Data processing and telecommunications, where links between foreign country and home office may be necessary to provide an effective service, are particularly vulnerable to unilateral requirements imposed by a single government. As the current leader in the provision of international services, the United States has a vital stake in helping to establish adequate rules governing the international trade in services.

The United States must also be concerned about how foreign regulations on foreign direct investment affect the ability of U.S.-based exporters to compete in world markets. In some cases, market access may depend on making a foreign direct investment. Until recently, it was virtually impossible for an American business to acquire a controlling interest in a Japanese firm and almost impossible to establish a new wholly owned manufacturing facility in Japan. Most economists are convinced that Japanese barriers restricting U.S. investments in Japan have limited the ability of U.S. goods to penetrate Japanese markets. In January 1980, Japan adopted a less restrictive law governing foreign direct investment. It is still too soon to say how much the change of the law will affect Japanese limitations on foreign investment, in practice.

The various requirements of many developing countries are also beginning to have an effect on U.S. exports to third country markets and on sales in the domestic American market. Many developing countries close their markets to imports through tariffs or other import barriers. To participate in the developing country market, a foreign-based firm will often have to establish a manufacturing firm in the developing country. In some instances, the developing country will require an investor to export a certain percentage of his output.

The growing competition for foreign direct investment can also affect trade flows. A foreign firm may be attracted to a country by a combination of tax incentives and government subsidies. The subsidies may cause lower cost production that will not only displace countries currently supplying the host country's market, but it may also make the new foreign investors more competitive in third country markets.

Keeping Domestic Markets Open

There is little a firm or industry can do to bring down interest rates or fight the domestic effect of a recession. They can, however, try to do something about imports.

Although the United States has the most open economy of any of the industrial democracies, it has occasionally applied trade restrictions to shelter a number of industries from foreign competition. In the wake of a recession, one can expect greater use of the existing remedies against unfair competition as well as an increase in "escape clause cases" under GATT rules where industries seek temporary protection from foreign competition that they cannot currently meet.

In the past, temporary relief to shield a domestic industry has generally been granted to final consumer goods—shoes, television sets, apparel, and, most recently, automobiles. In two instances, textiles and steel or steel products, the United States has sheltered industries whose production is not generally sold directly to the public.

The current contractions in the automobile industry are a stark reminder of how disruptive a change in preferences and the loss of competitiveness can be. Reducing the adjustment costs through slowing imports, however, can impose severe costs on the economy. The pattern of protection has been even more costly to the overall growth of the economy. By slowing the transfer of resources to emerging industries, the United States could be endangering its long-run industrial strength.

The Reagan Administration has repeatedly stressed its commitment to reliance on the working of international as well as domestic markets. Its trade policy has emphasized the need to keep the United States market open to foreign competition. In terms of actual trade decisions, however, the Adminsitration has not always practiced what it preached.

The most serious gap between rhetoric and reality was opened by the Administration's role in encouraging the Japanese to impose voluntary controls on automobile exports to the United States. Although Administration officials were in Japan shortly before the voluntary restraint arrangement was announced, they have denied any explicit role in setting the level of quotas or, in fact, determining whether or not export quotas would be imposed.

Whatever the extent of Administration involvement, they have set a dangerous precedent. In the 1970's, the American government negotiated import restraints only after the International Trade Commission had found that imports were a "major" or, more recently, a "substantial" cause of injury to a domestic industry. In the case of automobiles, the ITC has not found imports to be a substantial (i.e., more serious than any other) cause of the economic difficulties besetting the American auto industry. The Administration's involvement in the Japanese decision to impose voluntary export controls on autos is disquieting.

Building an Export Economy

In the long run, an effective domestic economic policy will do the most toward making U.S. goods competitive in foreign markets.

New mouse traps, high quality goods, and fair prices are all crucial ingredients in a U.S. export strategy. Elsewhere in this Report, the Committee spells out its own prescription for putting the United States back on the path to steady growth and international competitiveness.

The United States is in the midst of a gradual shift toward greater involvement in the world economy. In the past decade, the importance of the trade component of our GNP has more than doubled. Until early 1981, U.S. exports had grown rapidly for several years and appeared to be regaining some of the world share of manufactured goods that had been lost earlier in the 1970's. High interest rates and the overvalued dollar have since reversed that progress. The result has been large and increasing trade deficits, which contributed heavily to the recession.

The Administration's economic policies have worsened our external position which, in turn, has worsened the domestic economy. The sharp drop in the U.S. trade balance that resulted from these policies is a major contributing cause of the recession and will do continuing harm to the economy, the prospects for recovery, and trade policy. In all likelihood, the unfavorable trade balance will lead to more protectionist pressures and possibly to serious international monetary disturbances.

The trade deficit registered for 1981—$27.8 billion—in the face of a decline in oil imports, and the near record deficit for all merchandise trade—$37.7 billion—reflects a deterioration in the U.S. competitive position abroad. Simply stated, our imports greatly exceeded our exports. Had the trade balance not fallen so far, the recession may have been avoided despite the declines in housing and automobile production.

High U.S. interest rates underlie our trade difficulties. The perpetuation of high interest rates has led to the substantial overevaluation of the dollar in exchange markets, and to the overpricing of American goods. Export orders of major U.S. firms have gone down by about 40 percent while imports of goods such as steel and European autos have risen even though U.S. demand is weak. When the inevitable exchange-rate swing occurs, it may trigger a precipitous decline in the dollar as well as a new episode of severe international monetary instability.

In 1981, the U.S. merchandise trade deficit increased from the preceding year for the first time since 1978. Last year marked the fifth consecutive year in which the deficit exceeded $20 billion, a period during which the cumulative imbalance totaled $140 billion. The deterioration in the U.S. trade balance in 1981 was masked to some extent by a substantial reduction in petroleum imports since the beginning of 1981. But the low growth rate of recent exports contrasted sharply with the 18 to 27 percent annual increases in the preceding three years.

It is against this background that some trade experts are beginning to say that the dollar is more overvalued than it was when we went to flexible exchange rates in 1971 and devalued again in 1973. These trends coupled with a decline in relative productivity and international competitiveness must be closely monitored. We must not be lulled into any false sense of security by the following excerpt from the Economic Report of the President (pp. 180-181):

> One need not be concerned if the U.S. current account moves into deficit as domestic economic policies begin to revitalize the economy. With strong domestic performance, U.S. import demand will also strengthen; the effects of this revitalization on U.S. exports will take more time. Thus, a deficit on current account will simply reflect the adjustment process at work.

For much of the last two years, the effect of trade deficits on the value of the dollar has been more than offset by high domestic interest rates. The Department of Commerce has been put in the awkward position of creating export promotion programs that are more than offset by the effects of high interest rates.

The export programs of the Department of Commerce, however, remain important initiatives in the long-run effort of the United States to remain competitive in foreign markets. The efforts to create an aggressive and imaginative Foreign Commerce Service, trade fairs, the worldwide information base of trade opportunities, and other activities may, if implemented efficiently, help the American economy reap the benefits of foreign commerce.

Recommendation No. 32: International Financial Institutions

> **The United States should continue to support the World Bank, the Regional Development Banks, and the International Monetary Fund. In many countries, the Development Banks and the IMF have helped build the capital and human infrastructure which are necessary preconditions for a thriving private sector. Furthermore, the activities of the Bank and the Fund have been consistent with long-term U.S. economic goals. The Administration should take the lead in working for a seventh Replenishment of the International Development Association and the eventual expansion of IMF quotas.**

Although the world economy has undergone great change in the postwar period, the Bretton Woods institutions have proved remarkably resilient. The World Bank has successfully shifted its focus from reconstruction in the industrial West to the broader challenges of economic growth in the developing world. Despite the advent of floating exchange rates, the International Monetary Fund has continued to play an important role in policing international financial relations among the industrial democracies. In addition, the IMF has become much more involved with the attempts of developing countries to make the difficult structural adjustments required by the great jump in oil prices.

The Administration has adopted an equivocal approach to the World Bank and the regional development banks. The Treasury Department has spent more than a year working on a report detailing the effect of the banks on economic development and attempting to assess whether or not the development banks have served American interests.

The September draft of the Treasury report spoke in glowing terms of the Bank's past performance and found their activities consistent with American interests. Despite the words of praise for the Bank's performance, the September draft report proposed a steady reduction in the United States participation in Bank funding. To avoid loss of American influence within the Bank, other members of the Bank would have to decrease steadily their participation in the Bank as well.

This is not the time to curtail the activities of the development banks or their soft loan affiliates. The International Development Association and the soft loan windows of the regional development banks will continue to play a vital role in helping to modernize the least developed countries. Many countries are not yet ready to compete for commercial loans or for private foreign investment. For these poorer countries, foreign assistance and the IDA will continue to be important sources of development finance throughout the coming decade.

In the past, we have often looked upon foreign assistance and concessional loans as a reflection of our determination to eliminate poverty and suffering everywhere. Humanitarian concern has always been an important part of U.S. international economic policy. But concessional loans have also served our long-term political and economic interests. Several of the former recipients of IDA loans purchase a substantial portion of our manufactured exports and are likely to be even more important customers in the future. In a very real sense, economic modernization that is, in part, a product of IDA activity has served as a long-term program of export development.

The adjustment to high oil prices required a major restructuring of the economies of the industrial as well as the developing world. The high oil prices and the industrial world's adoption of restrictive policies slowed the demand for developing country exports of raw materials and manufacturers.

At the time of the first oil shock, the IMF could provide only a small share of the financing that would allow continued growth in the developing world. Caught between limited IMF funds and stagnating markets in the industrial world, a number of the more advanced developing countries turned to the commercial banks and the Eurodollar markets. American and other Western banks were quick to respond. Limited loan demand in their home countries and the prospect of attractive yields resulted in billions of dollars of lending to the developing world. In effect, much of the OPEC surplus was channeled back to the developing world by way of the commercial banking system. A similar pattern of borrowing took place after the second oil shock in 1979.

It is not clear that the commercial banks will continue to increase the amount of LDC debt in their loan portfolios. The industrial countries are in the midst of an attempt to modernize their traditional industries and continue to move into high technology fields. In many cases, the move toward industrial renovation has been accompanied by large public deficits. With growing demand in their secure home markets and an already large exposure to the developing world, commercial banks may be unwilling to play the same role in meeting the loan demand of the developing countries.

To complement the activities of the commercial banks, the IMF will almost surely have to assume an even larger role in dealing with the future payments difficulties of the developing world. Future growth of IMF resources therefore will be necessary for the smooth functioning of the international financial system. The Administration should begin laying the basis for a future increase in IMF quotas or an expanded IMF presence in world money markets.

Finally, to help the developing world complete the adjustment to high energy prices, measures to help diversify energy sources are needed. Discussions which might lead to the establishment of an energy affiliate for the World Bank have been stalled since the Cancun summit by a lack of interest on the part of the Administration. Such discussions should be resumed.

Recommendation No. 33: Global Negotiations

> **At the 1981 Summit in Cancun, the Administration expressed a willingness to move forward with global negotiations on international economic questions. It is time for the Administration to come forward with some specific proposals and a timetable for the negotiations. The Administration should formulate a coherent policy to promote economic growth in the developing world. Its agenda should include measures to encourage trade with the developing world, an emphasis on shifting bilateral and multilateral assistance to the poorer of the development countries, and policies that will facilitate additional private-sector investment in developing economies.**

During the past decade, the United States has multiplied its economic ties with the developing world. The United States now looks to a number of developing countries for almost all its imported oil, large amounts of strategic minerals, and important industrial raw materials. Manufactured exports from the developing world range from shoes and low-cost textiles to automobile engines and jet aircraft.

The developing world has also become a key market for U.S. exports. Developing countries now buy more U.S. manufactured products than do Europe and Japan combined. United States based multinational firms have invested tens of billions of dollars in manufacturing facilities throughout the developing world and U.S. base international banks have lent developing country governments and businesses many billions more.

In the early post-World War II period, the United States played a relatively small role in the developing world. The Good Neighbor policy and the pressures of the Second World War brought a flurry of activity in Latin America, but that activity slowed after the end of the War. Elsewhere, the developing world was still largely in European hands or fighting for national stability. Only gradually did the United States turn its attention from the reconstruction of Europe and Japan to the much more ambitious task of bringing economic prosperity to the whole world.

That early perspective of spurring economic growth is still very much a part of U.S. policy. But there is a new element. A vast array of economic ties between the United States and the developing world has created a broad range of very specific common interests. Dealing with the developing world has become very complicated and very big business.

For a variety of political and economic reasons, the developing countires have continued to press for global negotiations over proposals to change the nature of the international economy, increase the flow of resources to the developing world, and augment the voice of the developing world in existing international institutions. At the 1981 Summit meeting in Cancun, the Reagen Administration expressed a willingness to move forward with global negotiations. As yet, however, there has been no indication as to what the Administration will propose in terms of either a timetable or an agenda. It is time that the Administration took steps to follow up on its statements at Cancun.

Formulating a coherent policy for the developing world poses a considerable challenge. The developing world is made up of countires that differ greatly in terms of education, per capita income, health, degree of industrial development, natural resources, and size.

There are, however, several productive directions in which the Administration could move. At Cancun, the President spoke of the need to make broadly defined regions of the developing world self-sustaining in food and in energy. We encourage this approach. Renewed discussions on a World Bank energy affiliate would, as noted above, constitute a positive step in this direction. Similarly, an adequate level of U.S. grain reserves, which we recommend in a preceding section, would provide a safety net for third world agricultural policies, permitting the devotion of substantially increased resources to agricultural development projects whose benefits will be realized only over an extended period of time.

The poverty, sickness, and population pressure in many of the poorest countries also continue to demand our attention, for the most part, in countries that are not rich in raw materials or on the brink of successful industrialization. In a preceding section, we recommended continued support for the International Development Association. The United States could also concentrate its bilateral concessions on the poorer countries. For instance, several of the advanced developing countries might be graduated out of the provisions governing the Generalized System of Preferences (GSP), or poorer countries could be given larger quotas within the overall quota for textiles and apparel imports.

Recommendation No. 34: East-West Trade

> **The Administration should develop a coherent policy concerning East-West commercial and financial relations. There is an urgent need for the development of a unified approach with our allies in West Europe and Japan.**

During the past decade, expanded commercial and financial ties between the East and West have outrun the development of foreign economic policy in the United States and amoung our European and Japanese allies. The Nixon policy of detente with the Soviet Union and the initial opening to China laid the basis for Europe and Japan to expand their trade with China and the Soviet bloc countries. By the end of the decade, the Eastern bloc, including the Soviet Union, had become important markets for West Germany, France, and some of the other European countries. In the case of

West Germany, Eastern bloc trade was a high percentage of total production for a number of key industries.

Western, particularly West-European, banks provided the bulk of the credit to finance the expanding volume of East-West trade.

Suppliers credits from Western governments also played a role and, in many cases, private bank loans were guaranteed by West-European governments.

Although it was the political initiatives of the United States that opened the door to the rapid expansion of East-West trade, the United States limited its own participation. Congressional action made it difficult for the Soviet Union and several other Eastern bloc countries to gain most favored nation status (which would have reduced tariff barriers to trade) or Export-Import Bank credits. Despite these restrictions, however, a combination of poor harvests in the Soviet Union and elsewhere in the Soviet bloc coupled with the Soviet's long-standing desire to purchase high technology products increased U.S. exports to the Eastern bloc.

The Soviet invasion of Afghanistan brought a sharp halt to increased U.S. participation in East-West trade. President Carter imposed a range of sanctions, including a partial embargo on grain sales to the Soviet Union and additional restrictions on the sale of high technology goods to the USSR. The U.S. sanctions received little support from our allies and other noncommunist countries.

Up until December 1981, the Reagan Administration was slow to spell out is own thinking on East-West commercial policy. The President lifted the partial embargo on grain sales, but he decided to extend the grain agreement for one year rather than settling on a full five-year extension. Early estimates suggest that the Soviets will buy a record amount of U.S. grain under the terms of the one-year agreement.

The open door with regard to grain exports, however, has not been extended to East-West trade in general. The Administration refused to sanction butter exports to the Soviet Union and promised to take a harder look at licenses for high technology exports. The Administration also sought to discourage the West-Europeans and the Japanese from aiding the construction of a pipeline that would bring Siberian gas to a number of West-European countries. Despite Administration efforts, West Germany and other European countries have announced their intention of supplying the Soviets with goods and credits that will be used in building the pipeline. Once the decision was made, the Administration gave every indication of allowing U.S. firms or European firms using U.S. technology to participate in the export sales generated by the pipeline.

While the Reagan Administration was still seeking to define an overall East-West commercial policy, the imposition of martial law in Poland precipitated a rapid series of decisions. The Reagan Administration quickly announced a limited range of economic sanctions against Poland. Just a few days later, sanctions were also imposed on the Soviet Union. The United States announced its intention to refuse export licenses on equipment used for energy development and other high technology goods. Negotiations on a new maritime accord and a long-term grain agreement were also suspended. The Administration, however, has not restricted the sale or shipment of U.S. grain to the Soviet Union under the existing agreement, which has a year to run.

Once again, the Western Europeans were slow to emulate unilateral American action. Although Japan was quick to follow America in imposing post-Afghanistan sanctions, it too proved reluctant to follow the American lead on Poland.

The United States is the leader of the Western alliance and will inevitably be faced on occasion with circumstances in which unilateral action is necessary. We have not, however, done an adequate job of working with either Euorpe or Japan to define the circumstances in which trade sanctions will be necessary. Without European and Japanese support, most limitations on industrial trade will be ineffective.

The Administration has not yet faced up to such critical questions as: Are sanctions effective? When are they the preferred method of sending a message or taking a largely symbolic action? What strictly economic benefits flow from continued East-West trade? Do expanded commercial ties inevitably entail a loss of flexibility on both sides? In early February 1982, the Joint Economic Committee issued a study on where we stand in the formulation of East-West trade policy. Based on the responses of various Executive Branch departments to questions from Chairman Reuss, the study pointed up the need to make some hard decisions within our own Administration.

H. SAVING THE STATISTICAL SYSTEM

Recommendation No. 35: Save the Statistical System

Recent budget cuts threaten the quality, coverage, and continuity of vital economic statistics. In most cases, greater attention to the maintenance of the statistical function could preserve data-gathering capability without significant increases in budget cost or burden on the public. We recommend that:

Further cuts in the budgets of the Bureau of Labor Statistics and Census Bureau not be made, since these cuts threaten the integrity of core economic data.

The Administration strengthen the statistical policy coordination function, either by providing it with strong leadership and increases in staffing within OMB, or by establishing a separate Office of Statistical Policy outside OMB.

The Special Analysis of statistical policy in the President's budget, discontinued in 1979, be restored.

The budget cuts enacted for Fiscal Year 1982 and the additional reductions proposed for Fiscal Year 1983 threaten to turn the American statistical system into a shambles.[19] These cutbacks represent a penny-wise, pound-foolish approach, an extreme cause of false economy. Budget reductions leading to deterioration in the quality of the Consumer Price Index could lead to an overstatement of the increase in the cost of living, causing billions of dollars in excessive payments in those entitlement programs covered by escalator clauses. Alternatively, lowered quality of our statistical system could lead to understatement of the rise in living costs, causing millions of citizens to be deprived of the benefits to which they are rightfully and legally entitled. *A priori,* it is impossible to determine if deterioration of the statistical system would be a case of false economy or if it would lead to the deprivation of benefit entitlements, but it is virtually certain that one of these two consequences will result. If Congress wishes to make adjustments in entitlement programs, they should be made after open discussion and debate on the programs themselves, not by the unforeseen and unknown consequences of cuts in statistical budgets.

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[19] Additional discussion is found in "Maintaining the Quality of Economic Data," a study prepared for the Joint Economic Committee by Dr. Courtenay Slater, November 27, 1981.

To date, the statistical agencies have dealt with budget retrenchment in a professionally responsible way, attempting to minimize the damage to our economic data and programs. But the additional cuts in the Fiscal Year 1982 continuing budget resolution and those in the President's Fiscal Year 1983 budget proposal threaten to undermine the cornerstones of our statistical system. The United States was the pioneer in many areas of statistical design, development, and application, and has long had one of the world's best statistical systems. It is now in serious jeopardy. Some data series that are available in other industrialized countries are being discontinued in the United States, and the quality, coverage, and timeliness of other series are being reduced.

There have been several occasions in the past when errors in data led to mistakes in economic forecasting and to policy steps which might not have been taken with more accurate statistics. Serious understatement of inventory accumulation in 1973 and 1974 disguised the unwanted inventory buildup at the onset of the recession, contributing to the underestimation of the depth of the decline. (On a smaller scale, a similar situation arose in the third quarter of last year, when the preliminary GNP estimate showed inventory accumulation at a $17.6 billion annual rate; this was subsequently revised to $24.3 billion and then to $27.5 billion.) In another case, the benchmark revisions of GNP in December 1980 added 8 to 10 percent to the previous estimates of total business fixed investment for 1977 to 1979. Because the greatest underestimates were in the most recent period, the growth rate as well as the level of investment had been underestimated. This in turn led to somewhat erroneous estimates of the causes of our productivity slowdown.

Specific effects of the recent cutbacks in budgets and personnel include:

(1) The Consumer Price Index overstates somewhat the increase in the cost of living over the last decade because the expenditure weights are based on the buying patterns of consumers as determined in a survey of consumer expenditures conducted in 1972 and 1973. Thus, for example, the CPI currently does not take into account the many steps taken to conserve energy in response to the 260 percent increase in energy prices since 1972. To remedy this, the Bureau of Labor Statistics (BLS) has initiated a continuing expenditure survey of current buying patterns, but no funds have yet been appropriated to incorporate the results of this survey into the CPI.

(2) The official measure of the incidence of poverty is misleading, because it fails to take into account "in-kind" income (Food Stamps, housing subsidies, fringe benefits, and other income supplements). The Cesus Bureau and the Department of Health and Human Services had planned a new survey, to remedy these deficiencies, but the survey has been dropped.

(3) The quality of data about State and local areas is being reduced and some series are being discontinued altogether. Improvements had been planned by BLS in State and local unemployment information, used in the allocation of $17 billion of Federal funds. These plans have now been dropped and budget cuts have forced economies which could lead to deteriorating quality and possibly to misalocation of funds. Detailed information on employment and payroll by industry, monthly estimates of retail sales by geographic area, and State and SMSA data from the annual survey of manufacturers will all be dropped by the Census Bureau. Population data used in the distribution of revenue sharing funds will be gathered biannually rather than annually. State and local data will be increasingly important in evaluating the prospects for the "New Federalism" proposed by President Reagan.

(4) BLS monthly surveys on labor turnover and on construction materials requirements will be eliminated. The comprehensive series on work days lost due to stikes will be severely reduced, leaving the United States as the only industrialized country with little information on current strikes. Information on collective bargaining agreements and wage surveys in many key industries, used fequently by both sides in contract negotiations, will also be curtailed due to the severe budget cuts imposed on the Bureau.

(5) Concern among new entrants to the labor force about employment is very high, with the youth unemployment rate of nearly 22 percent. The "Occupational Outlook Handbook" is a valuable, widely used reference for counselors and jobseekers, but the number of occupations covered and the scope of the projections are being reduced.

(6) Discussion and analysis of our productivity decline have been hampered by the fact that the official productivity measures only take into account the role of labor input, neglecting capital, energy, and other factors. In previous years, this Committee has endorsed development of productivity measures for these other determinants of output and of an overall multiple factor productivity index. BLS intends to develop such measures, but their plans have been delayed.

(7) Sample sizes will be reduced in a variety of surveys, including the Consumer Price Index and the Current Population Survey, and other data will be delayed. These changes are not dramatic, but may prove to be the most insidious of all.

The impact of the budget cuts and personnel reductions is exacerbated by the fact that many requirements for the collection or use of statistics have been written into law with insufficient consideration of the cost involved. For example, the preparation of "paperwork budgets," estimates of foreign direct investment required by the International Investment Survey Act of 1976, and per capita income estimates required for the revenue sharing program have all added significantly to the work load of the statistical agencies.

In these times of budgetary stringency, major improvements in our statistical system may be difficult, but we should at least try to hold the line to prevent further deterioration. Steps which could be taken include:

(1) Resumption of the Special Analysis of statistical programs in the President's budget. This was carried out until the Fiscal Year 1979 budget, and it provided at least a partial overview of the statistical program. The Congressional Budget Office could prepare a similar document if the Special Analysis is not resumed.

(2) In budget decisionmaking, attention should be given to the statistical program as a whole, even though the agencies involved are located in many different departments. This would help prevent unintended damage to one specific part of the statistical program arising from disproportionate cuts for certain agencies. For example, under the current continuing budget resolution, BLS has been subject to a 4 percent cut on top of the earlier 12 percent cut. This exceeds the reduction for some of the other major statistical offices, even though BLS publishes key indicators such as the CPI and the employment measures.

Better coordination of statistical policy can be achieved in several different ways. The function of statistical policy coordination can be strengthened in its current location within the Office of Information and Regulatory Affairs at OMB, or moved to another office within OMB, or established as a separate Office of Statistical Policy outside OMB.

(3) Legislation to permit statistical agencies to make shared use of the Census Bureau's Standard Statistical Establishment List (SSEL) under strict confidentiality safeguards should be considered. This list would permit more efficient survey techniques, and reduce both costs and the reporting burden on the public. At the same time, it would improve the quality of the data collected by permitting greater comparability among statistical series collected by different agencies.

Recommendation No. 36: Needed: More and Better Information

The amount and quality of economic, social, industrial, and technological information available today are manifestly inadequate to the needs of modern government, particularly for the formation of sensible economic, military, regulatory, industrial, and productivity policies. Moreover, failure to coordinate the use of existing data and economic models, coupled with political manipulation of key assumptions, has helped undermine the quality and the credibility of basic economic policy decisions, especially with respect to the budget.

In the preparation of this Report, we have encountered again and again situations in which the information needed to answer a vital question of public policy did not exist. For example, we could not predict when or if inflationary pressures due to bottlenecks will arise from the present military buildup, because the data do not exist. We could not, at first, analyze the effects of the Administration's tax program on income distribution, because a model appropriate to this task did not exist until we built one. We could not make a definitive analysis of the effects of diverse policies on the competitiveness of basic industries, because no authoritative source of comprehensive information exists. Our analysis of the fiscal condition of American cities is hampered by a lack of timely information in the Executive branch, and so we have to rely on spot surveys which we conduct ourselves. Likewise, there is no national inventory of infrastructure investment needs, no national assessment of prospects for high technology industries, and nothing remotely resembling a comprehensive evaluation of the effectiveness of labor training programs. And the many economists who have attempted to analyze the sources of productivity decline or the costs and benefits of various regulatory policies know all too well how little information is available.

At the same time, fairly substantial resources have been invested by many agencies of the government in the development of econometric models, many of which bear little relation to each other. The situation described by the Advisory Committee on National Growth Policy Processes to the National Commission on Supplies and Shortages in 1976 still largely holds true today:

> The Departments of Commerce, Labor, Agriculture, and Interior, the Federal Energy Administration, and the Environmental Protection Agency all use econometric models to forecast the progress of the national economy or of narrowly defined sectors of it. These models are written in diverse computer languages and usually cannot "communicate" with each other. Their output is not easily compared; their underlying assumptions about the state and future of the economy vary widely.

More recently, a new problem has emerged: the politicization of econometric forecasting within the government. It is well known that small variations in the rates of growth, inflation, unemployment, and interest rates assumed in projecting Federal expenditures and revenues on a multi-year basis, as required by the congressional budget process, can have a large effect on those estimates and thus on the size of the projected future budget deficit or surplus. Past Administrations largely avoided the temptation to manipulate underlying economic assumptions for political effect. This Administration, faced with a Presidential promise to balance the budget in 1984 and no policies capable of reaching that goal, succumbed in 1981. The result has been a severe deterioration in the credibility of economic forecasting done by the Office of Management and Budget, and a potentially dangerous loss of public confidence in government economic forecasting generally.

On January 19, 1982, the Committee heard testimony on the need for improved information services from Professor Wassily Leontief. Professor Leontief's testimony makes the essential case for a new direction in U.S. statistical policy, and we quote it here at length:

The United States is the only advanced, industrialized country that still does not possess a real, central statistical office responsible for collection, systematic organization, and dissemination of facts and figures pertaining to population, natural resources, technology, and other aspects of the national economy and society. As things stand now, each department and each agency of the Federal and of most local governments compiles data of one sort or another that it happens to need or has needed in the past in connection with the discharge of its administrative or regulative responsibilities. While it collects and publishes more data than any other agency of the government, the Bureau of the Census is not a real central statistical office. Confronted with a giant jigsaw puzzle, economists and statisticians working in the government or private business, as well as those engaged in academic research, spend a large part of their time trying to put its pieces together, that is, to reconcile incompatible figures coming from different sources and to fill as well as they can the gaping holes in the total picture.

What a contrast with the Statistical Organization of Japan or even that of a small country like Norway which has decided recently to discontinue its census because, as it was explained to me, all data needed for government planning, business planning, and independent research are collected, systematized, and brought up to date continuously, month by month and year by year. The compilation of a decennial U.S. Input-Output Table is assigned to a small team tucked away in one of the many bureaus of the Department of Commerce; its printed version consists of two modest 150-page-thick paperback pamphlets. The compilation of the most recent Japanese Input-Output Table was carried out by the combined effort of 13 ministries under the general supervision of a committee of the Counsel of Ministers. The amount of information presented in five hardcover folio volumes containing the Japanese Table is several times larger than its United States counterpart; and it was compiled much faster.

Creation and maintenance of a comprehensive data base would permit a drastic reduction in the amount of guesswork, and one might add, of idle theorizing that is involved in our policymaking process now. But as I said before, providing the requisite data base is not enough. The time has come to take a decisive step by setting up a strong, autonomous research organization analogous to the Congressional Research Service, but more authoritative and much larger, that would provide all branches and agencies of the government with the technical support needed for developing a systematic, coordinated approach to development and practical implementation of national and local, general and sectoral economic policies.

This organization should also be responsible for monitoring, in great detail, developments in all parts of the United States economy, with emphasis on changes in their

> interdependence, and whenever necesssary, on changes in the structure of the world economy. It should be able to identify the existing and anticipate the potential trouble spots. The analytical capabilities of this organization should be engaged not so much in futurist prediction but rather in elaboration of alternative scenarios each describing—with emphasis on sectoral and regional detail—the anticipated effect of any particular combination of national, regional, and local economic policies. This is, in fact, the only means by which the government and the electorate at large would be enabled to make an informed choice among alternative policy actions.
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> While providing research support to legislators and administrators responsible for the overall direction of national economic policies and assisting in the choice of appropriate methods for their practical implementation, the proposed technical organization should be involved in final decisionmaking only to the same limited extent as is, for instance, the Bureau of Labor Statistics in the Department of Labor, or the Bureau of Economic Analysis in the Department of Commerce. To discharge effectively the responsibilities assigned to it, this independent agency should, however, have a decisive voice in determining the direction and scope of the data-gathering activities of the Federal and, in some instances, on a consultative basis of State and local governments.
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> The data-gathering and monitoring operations comprising also the formulation of alternative scenarios would eliminate or at least reduce to reasonable proportions one of the most wasteful and futile aspects of the present policymaking process which for what of a better word I call 'adversary fact finding.' Studying the supposedly factual reports contributed by the interested parties, one cannot help but be reminded of testimonies presented by witnesses summoned by both sides before a judge trying to find out what has actually happened in an automobile accident. The policymaking process would be much more effective if it did not imitate a traffic court but rather were modeled along the lines of a formal arbitration procedure. The arbitrator first establishes the relevant facts and only after does he proceed to explore alternative paths toward a workable agreement.

We recognize that his is an ambitious proposal, not consonant with the political realities of the present budget debate. Sooner or later, however, the present crisis will pass, and the time for a serious reexamination of the adequacy of our information base will arrive. We are convinced that the need of the Information Economy for a vastly expanded reservoir of information about itself will then become apparent to all.

Part III. REVIEW OF THE ADMINISTRATION'S PROGRAM FOR ACHIEVING THE OBJECTIVES OF THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978 AND REVIEW OF THE CURRENT SERVICES BUDGET

The Humphrey-Hawkins Act (The Full Employment and Balanced Growth Act of 1978) established national goals of full employment, price stability, and a reduction of the share of gross national product represented by Federal outlays. The President is admonished in that Act to pursue economic policies designed to rapidly attain those goals and to present those policies annually in his Economic Report. Interim goals are specified in the Act, as well, as both a guide and a measure of progress toward those goals. The interim Humphrey-Hawkins inflation goal is 3 percent in calendar 1983; the unemployment goal is 4 percent for that year; and the Federal outlay goal is 21 percent for calendar 1981. Under the proposed Administration economic program, none of these goals will be met. By the Administration's own forecast, inflation as measured by the Consumer Price Index, would be 5.1 percent in 1982, the unemployment rate would be 7.9 percent in 1983, the Federal outlays amounted to 23 percent of GNP in 1981. Indeed, no progress toward reining in government outlays or reducing unemployment compared to 1978 is estimated to occur as a consequence of this program. Unemployment in calendar 1983 is projected to be 1.8 percentage points above the calendar 1978 level of 6.1 percent. And, under the Administration's proposals, even projected Fiscal Year 1983 outlays will represent a larger share of GNP than did such outlays in calendar 1978.

Some progress in slowing inflation is projected by the Administration toward achieving the interim goals for our Nation contained in the Humphrey-Hawkins Act. But these same projections indicate that attainment of goals for unemployment and for controlling Federal outlays will be farther away in 1983 than when the Humphrey-Hawkins Act was signed into law.

The Humphrey-Hawkins Act calls for simultaneous reduction in both inflation and unemployment. The Administration predicts that this will happen, but, as discussed elsewhere in this Report, their policies will not work to achieve it. Rather, the Administration's monetary policy will reduce inflation only at an enormous cost in lower production and higher unemployment. This is in conflict with the Humphrey-Hawkins Act, which states that "policies and programs for reducing the rate of inflation shall be designed so as not to impede achievement of the goals and timetables . . . for the reduction of unemployment."

The Administration also advocates a fiscal policy which contributes, through tax reduction and military spending increases, a measure of fiscal stimulus. But any beneficial effect on unemployment of this stimulus is likely to be offset by draconian monetary restraint. And as outlined in the Report, significant inflationary risks arise from the scale of the defense buildup and from the huge deficits anticipated for future years. Monetary and fiscal policy simply cannot be compartmentalized, with one being used to fight inflation and the other to reduce unemployment, as the Administration appears to believe.

The Administration is paying lip service to the Humphrey-Hawkins goals, but is pursuing contradictory policies that will prevent their achievement, and is rejecting additional policies which could help in their attainment.

CURRENT SERVICES BUDGET ESTIMATES

The Congressional Budget Reform and Impoundment Control Act of 1974 requires that the President submit a current services budget to Congress. This budget notes the level of outlays and budget authority consistent with maintenance of existing program levels. Such benchmark estimates and the corresponding current services receipts estimates play a vital role in expediting efforts of congressional committees and the Administration to develop and evaluate timely and credible policy alternatives. The Administration's proposed outlays and receipts for Fiscal Year 1983 are compared with the corresponding current services outlays and receipts in Table III–1.

TALBE III–1.—RECEIPTS BY SOURCE AND OUTLAYS BY FUNCTION, ON CURRENT SERVICES BASIS AND AS PROPOSED BY THE ADMINISTRATION, FISCAL YEAR 1983

[In billions of dollars]

	Current services basis	Administration proposal	difference
Receipts:			
Individual income taxes	301.0	304.5	3.5
Corporation income taxes	56.2	65.3	9.1
Social insurance taxes and contributions	223.6	222.5	−1.1
Excise taxes	40.4	41.7	1.3
Other	32.1	32.1	0.0
Total	653.3	666.1	12.8
Outlays:			
National defense	202.3	221.1	18.8
International affairs	11.7	12.0	0.3
General science, space, and technology	7.6	7.6	0.0
Energy	5.5	4.2	−1.3
Natural resources and environment	10.7	9.9	−0.8
Agriculture	4.5	4.5	0.0
Commerce and housing credit	3.6	1.6	−2.0
Transportation	20.9	19.6	−1.3
Community and regional development	7.3	7.3	0.0
Education, training, employment, and social services	26.7	21.6	−5.1
Health	82.5	78.1	−4.4
Income security	271.5	261.7	−9.8
Veterans benefits and services	24.9	24.4	−0.5
Administration of justice	4.8	4.6	−0.2
General Government	4.8	5.0	0.2
General purpose fiscal assistance	6.6	6.7	0.1
Interest	115.1	112.5	−2.6
Allowances	1.5	−1.3	−2.8

TALBE III-1.—RECEIPTS BY SOURCE AND OUTLAYS BY FUNCTION, ON CURRENT SERVICES BASIS AND AS PROPOSED BY THE ADMINISTRATION, FISCAL YEAR 1983—Continued

[In billions of dollars]

	Current services basis	Administration proposal	difference
Undistributed offsetting receipts	−33.4	−43.5	−10.1
Total	779.3	757.6	−21.7
Deficit (−)	−126.0	−91.5	34.5

Source: Office of Mangaement and Budget, the Budget of the United States Government, 1983, Special Analysis A, Current Services Estimates, pp. 7-8.

Since the Fiscal Year 1981 budget, the economic assumptions utilized in the current services estimates and other components of the President's budget have been identical. That practice was continued in preparation of the Fiscal Year 1983 budget documents, as well. That uniformity resulted from repeated recommendations by this Committee that economic assumptions, particularly regarding inflation, for each program be consistent. Last year, the Committee recommended modifications of Section 605 of the Congressional Budget Act to:

> Require submission by the President of a current services budget by January 31 of each year, with the Joint Economic Committee evaluation to follow by March 1. This change would make the law consistent with the present satisfactory practice.

That Act now requires submission by the President of current services budget estimates on or before November 10 of each year, and the Committee's evaluation of such budget estimates must be submitted to both Budget Committees by December 31. Compliance with these deadlines has typically not occurred because it would reduce the usefulness of the evaluation which of necessity would be based on assumptions not necessarily adopted for the ensuing budget. The proposed modification has not yet been made, and the Committee again urges that this step be taken.

In previous years, this Committee has called for more detailed current services estimates for a five-year period, to facilitate longer run policy formulation. The Administration has provided projections of outlays on a "current services baseline with adequate defense" basis for Fiscal Years 1982 to 1987.[1] The estimates for Fiscal Years 1984 to 1987 are deficient on two counts:

(1) They combine two very important but very different concepts—current services and an "adequate defense." The basic rationale for the current services budget is that it is intended to provide objective estimates of spending in the absence of policy changes. By combining it with the much more subjective (though important) concept of an "adequate defense," the estimates lose their meaning and, in fact, they create confusion. At a minimum, strict current services estimates should also be provided for in Fiscal Years 1984 to 1987 so that Congress can

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[1] 1983 Budget, pp. 3-6.

better see what the Administration means by "adequated defense" for those years.

(2) Rather than projections of total current services outlays only for Fiscal Years 1984 to 1987, additional detail should be provided. This would facilitate the congressional budget process.

A summary of the current services budget estimates under the "higher growth scenario" and "lower growth scenario" altenatives to the Administration forecast would also be useful.[2]

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[2] Those alternatives are summarized in the 1983 Budget, pp. 2-11.

PART IV. ADDITIONAL VIEWS

SEPARATE VIEWS OF SENATOR LLOYD BENTSEN

Chairman Reuss, the full Committee, and staff are to be complimented for the diligence and effort involved in preparing the views presented in this Report. While there are parts of the Report which I cannot endorse, the views presented in it will contribute to the current economic debate.

The Report contains elements which I supported while Chairman of the Committee, including a monetary policy that is restrained but allows money growth necessary to finance economic growth, the availability of credit to finance productive purposes, efforts to promote a strong economy and a rapid return to a balanced budget, fairness in our tax laws, the removal of excessive regulations and red tape, the absolute need to promote the housing industry, the need for more skilled labor, and greater domestic energy production. And, while I do not endorse a number of the recommendations, analyses, or views printed in this Report and am filing separate views, I join the full Committee in transmitting them as required by the Employment Act of 1946, As Amended, to the Congress. My views are presented in this Separate Views portion of the Report.

Our economy faces a major challenge in attaining the robust economic recovery this year necessary to quickly reduce unemployment and reduce the Federal deficit. Overcoming this challenge requires a bipartisan approach by Congress and the Administration. Our economy is neither Republican nor Democratic. It is a national one and a joint national effort is urgently needed to restore it to health.

The focus of economic policy this year must be to establish the foundation for a strong and sustainable economic recovery, while reducing the Federal deficit without a resurgence of inflation. Rapid economic growth is the key to turning the American promise of a meaningful and productive job into reality. It is the key to unleashing the American productive genius and meeting the flood of high quality, competitive imports. It is the key to providing our Nation with both the necessary level of military preparedness and adequate investment in plant and equipment for the production of consumer products and, it is the key to reducing the Federal deficit.

Meeting the challenge of building a solid foundation for economic growth requires a coordinated monetary and fiscal policy.

MONETARY POLICY

Last year, an extraordinarily tight monetary policy in the second and third quarters cut short a hopeful economic recovery. Interest rates rebounded as a result to near-record levels and plunged interest-sensitive industries, such as housing and autos, into a severe recession. Housing starts in 1981 fell to a 35-year low. Thrift institutions, timber, and other related industries scored record losses.

Auto production in December reached a 20-year low. And the number of bankruptcies among small businessmen and women rose over 40 percent. The tragedgy of unemployment increased sharply, as well, with 2 million fewer men, women, and youths gainfully employed in December than in May. Almost 800,000 Americans left the labor force completely in that period, frustrated in their search for employment.

Lower interest rates are a prerequisite for a robust economic recovery this year. Reducing interest rates will require a consistent, moderate, and predictable monetary policy from the Federal Reserve Board of Governors, one which can accommodate a recovery without rekindling inflation. The Board of Governors should pursue a moderate monetary policy designed to lower interest rates, and avoid a return to loose money or "stop-go" monetary policies.

FISCAL POLICY

A record deficit is projected for the current fiscal year which will approach or even exceed $100 billion. A sizable portion of this deficit is the result of sliding tax receipts and rising Federal outlays related to the recession. Even so, financing this deficit and traditional off-budget Federal borrowing will place substantial pressure on capital markets and interest rates. Should the Board of Governors pursue the monetary policy just advocated, this pressure should not prevent an easing of interest rates as inflationary expectations subside. But Congress and the Administration cannot and must not place the full burden of generating and sustaining a robust economic recovery on the Federal Reserve System. Vigorous and effective steps must be taken immediately to reduce the Federal deficit for the current Fiscal Year and the large deficits projected for future years, as well. A tighter fiscal policy stessing substantial reductions in the deficit must go hand-in-hand with a moderate monetary policy.

Reductions in the deficit require action on both government spending and taxes. Further aggressive actions to hold down Federal outlays must be built around a bipartisan consensus of cuts in Federal programs developed jointly by both Houses of Congress and the White House. These reductions must include continued vigilance to reduce waste, fraud and mismanagement in government programs. Restrained Federal spending should be accompanied by an acceleration in the use of private contractors to perform those activities now conducted relatively inefficiently by Federal agencies. Congress should not escape the budget knife either. Improvement in the Nation's military posture is critical and that requires increased spending for national defense. Strengthening this Nation's defense demands not only that we spend enough to get the job done, but that we make sure the money is well spent.

The deficit should be reduced by steps to boost Federal tax receipts, as well. In particular, the transferability of or leasing of tax benefits, such as the investment tax credit and depreciation, should be eliminated. This one step will reduce the Federal deficit by as much as $80 billion over the next decade. Congress should review a variety of other options to enhance revenues, as well, and keep open the option of postponing the 10 percent personal income tax reduction scheduled for 1983. Given the current recession, however, I feel it would be a mistake to postpone the 10 percent individual tax cut scheduled for July, 1982.

In addition to a bipartisan effort to reduce the Federal deficit, Congress can and should work to ensure that the Federal budget treats all groups and regions in this country fairly and equitably.

SKILLED LABOR SHORTAGES

As the Democratic Views presented in this Report note, our Nation confronts the prospects of substantial shortages of specialized labor skills this decade. The magnitude of these shortages depend on the rate of economic growth, but any shortages would debilitate efforts by the private sector to meet necessary defense obligations and maintain accustomed American positions in world markets, especially in high technology products.

Provisions of the Economic Recovery Tax Act of 1981 provided needed incentives for savings and investment in new plant and equipment. Improvements in the pace of such private investment is a necessary component in rebuilding our Nation's productivity. Equally important in building a productivity boom, however, is a resurgence in the skills brought by men, women, and youths to the workplace. Our Nation should take steps designed to increase the quantity and quality of skills in our workforce. These steps should focus on those skills which are projected to be in short supply as our Nation turns to increasingly complex new production techniques in the future.

HOUSING

The persistence of excessive interest rates continues to depress our critical housing sector. The pace of recovery in housing will be slow even once interest rates begin to abate because mortgage rates typically lag behind interest rate movements. Yet, a great deal of this Nation's success in moderating Federal deficits and meeting necessary military and defense obligations depends on a rapid and robust economic recovery in 1982. That robust recovery cannot occur without a resurgence in housing. Specific Federal assistance in 1982 to spark that resurgence is necessary and a bipartisan congressional and administration effort to quickly design and implement such assistance should occur.

WORLD AGRICULTURAL TRADE

The financial crisis confronting American farmers is deep and pervasive. The American farmer is worse off now than at any time since the Great Depression. This reality conflicts with the general impression of our food and fiber sector. Our food stores are brim full. American consumers pay only 16 percent of disposable income for food, the lowest percentage in the world. Our farmers' productivity is the best in the world. While total U.S. merchandise trade wallowed in a $40 billion deficit last year, U.S. agriculture trade was $26 billion in surplus.

Yet, a different picture emerges if we look below this veneer of success. Profit margins for most major crops have dropped nearly 50 percent since 1974. Net income per acre has skidded from $11 in 1950 to barely $4 today. Total real net farm incomes in 1980 and 1981 were the lowest since the Depression. Many forecasters suggest 1982 could even be worse. The farmer's purchasing power from crop sales is only one-half what it was 30 years ago. The American family farm is a capital-intensive, leveraged activity that must service an increasing debt to maintain its capital equipment. Farm debt is growing twice as fast as farm income and was up 74 percent from 1976 to 1980. Yet, domestic farm prices received by farmers increased only 31 percent in the same period.

Agricultural exports are the critical difference between profit and loss for farmers. We are the world's leading agricultural trading Nation. In Fiscal Year 1971, the United States supplied 36.7 percent of world wheat exports and 41.3 percent of world exports of coarse grains. By 1980, U.S. wheat and coarse grains export percentages had risen to 41.1 percent and 69.1 percent, respectively. Exports provide 25 percent of all U.S. farmers' market returns today. We export one-half of all our crops by value, and about 60 percent of the value of our wheat, rice, and soybeans.

The highly leveraged and mechanized U.S. agricultural industry is increasingly dependent on access to world markets. Yet, this dependency threatens to turn against the American farmer. Instead of unrestricted access to world markets, the American farmer has been subjected to agricultural embargoes and is being branded an unreliable supplier. Instead of competing in a free world market with prices set by the laws of supply and demand, American farmers are forced to sell in foreign markets where price is artificially depressed by direct subsidies to local farmers or by the dumping of subsidized exports from other countries. The more efficient American farmer is not given an opportunity to compete with farmers in other countries. Rather, those markets are too often supplied by the most heavily subsidized producer, and the use of such subsidies is widespread.

The Secretary of Agriculture estimated last year that European trade barriers and agricultural export subsidies cost U.S. wheat farmers 50 cents per bushel in reduced market prices and cost the U.S. Treasury $400 million in wheat deficiency payments. Bolstered by a gigantic $13 billion annual subsidy, European Community farmers have become the world's biggest exporters of dairy products, sugar, barley, wheat flour, and poultry. The European Community made an agreement with us to import 10,000 metric tons per year of U.S. beef, but it has imported no more than 2,000 tons in any year since. Its subsidies for grain production, up to $2 per bushel in the case of soft wheat, and up to 100 percent in the case of other commodities, actually enabled the European Community to become a net grain exporter in 1980 for the first time.

Japan imposes similar barriers to the free trade of U.S. food and fiber, as well, including strict quotas on U.S. imports. Its last concession on U.S. meat imports amounted to only one hamburger patty per Japanese per year. And, in recent years, Japan has dumped portions of its heavily subsidized rice crop in traditional U.S. markets overseas.

A variety of international agreements have been constructed to clarify permissable trade practices. The major purpose of these agreements, represented by the General Agreement on Tariffs and Trade (GATT), is to provide rules designed to promote stability and predictability in would trade. In agriculture commodities, a number of these rules are ambiguous and go unenforced. In part to rectify this shortcoming, an agricultural subsidy agreement was negotiated during multilateral trade negotiations (MTN) which led to the Trade Agreements Act of 1979. This Subsidy Code provided that, in addition to the preexisting GATT rules, parties may not grant export subsidies on agricultural products in a way which either displaces exports of another nation or which brings prices for subsidized exports materially below those of other suppliers to a particular market.

The United States has abided by GATT and the MTN Subsidy Code. And we should continue to do so in order to set a positive example for a more open world trading system. But many other nations have not. These trade agreements contain enforcement provisions and outline procedures for resolving disputes. However, the United States has been very reluctant to use the complaint process for fear of offending other countries. Yet, our quiet diplomatic approach to discussions of foreign agricultural subsidies are consistently turned aside in Europe and elsewhere. These foreign representatives talk but nothing changes except the financial crisis affecting our farmers.

Our Nation's approach to unfair agricultural trade subsidies and barriers abroad must begin to protect the farmer. More action is urgently needed including the aggressive use of enforcements provisions by the Special Trade Representative. We need an announced national policy of unilaterally identifying trade problems and bringing them up in the GATT. Specific or generic trade problems, such as the European Community's export subsidy program, should be studied in great detail and provisions which violate the GATT and MTN Subsidy Code exposed to the glare of publicity. Formal GATT and MTN Subsidy Code cases should be initiated by the government, as well, and the cumbersome complaint procedure itself sharply truncated.

The trade policy of the United States is not to freeze international market shares in agricultural products at some past, present, or future level. Nor is it to attack any common policy of a united Europe. We do have laws to attack the unreasonable and unjustifiable practices of our trading partners, especially where those countries—by actions inconsistent with their international trade obligations—impair our own access to foreign markets. Our government must begin the task of seeing that these laws are enforced. This does not mean protectionism. Quite the opposite. It means movement towards a fair and open trading system, toward an international economic system which works, not one increasingly hamstrung by tariffs, nontariff trade barriers, and gigantic export subsidies.

LLOYD BENTSEN.

ADDITIONAL REMARKS BY SENATOR WILLIAM PROXMIRE

This country faces an interest rate recession.

This is not 1932 when there was falling demand, falling prices, and falling interest rates.

This is 1982 and a half century later. Prices are still rising at historical rates for a recession.

Interest rates are at an all-time recession high.

There is great need for housing, automobiles, and consumer goods, but credit for consumers, small business, farmers, and others is in short supply or nonexistent. Even when it is available, these groups cannot afford the interest rates or carrying charges to borrow the funds.

The causes of the 1982 recession and the 1932 Depression are far different too.

In 1982, we face a collision between monetary and fiscal policies.

By historical standards, we have a restrictive monetary policy.

But we have, at the same time, a super inflationary fiscal policy.

The President proposes a $91.5 billion deficit in his new budget which we all know, if no changes at all are made, will actually be far in excess of $100 billion. As in virtually every President's budget, revenues are exaggerated, spending is underestimated, and the economic forecast is optimistic.

What this means is that for at least the net three years in a row the budget deficit will exceed $100 billion a year.

The reaction of the financial community and the credit markets to this has been dramatic. They know these huge government deficits will continue to crowd out funds needed for the private sector—for housing, automobiles, investment, and consumer goods. A measure of the dimensions of that problem is the next year the government itself will sop up $206 billion, or more than half, of the new credit available to the economy.

As a result, we are now building fewer than one million houses a year when we need two million. The automobile industry is a basket case. These conditions cost the country at least two million jobs in construction and hundreds of thousands of jobs in autos, steel, glass, aluminum, and other sectors serving the domestic auto industry.

The answer to this is not a massive new public works spending spree. We cannot spend our way out of a recession caused by high interest rates and rampaging inflation.

What we must do instead is to cut the budget sufficiently to make major progress towards a balanced budget and to produce a program which will actually bring a balance in the next two or three years—by the President's fourth year in office as he promised during the 1980 campaign.

The President and the Congress must bite the bullet and cut spending to bring this about. To the degree that cutting spending is not sufficient to get the job done, we must raise revenues to make up the difference.

This is the hard, tough, painful prescription.

We cannot spend our way out of this interest rate recession. That will make matters worse. We cannot get out of the mess by shooting the messenger, by blaming the Federal Reserve, or by printing money.

We must get ourselves on a balanced budget track now. We should provide a balanced budget in any year in which unemployment is at 7 percent or below. And we must do this first by a massive cut in spending which the American people perceive as just and fair and which shares the burden equally, and second by increasing revenues to the degree that spending cuts are inadequate for the job.

This is a new kind of recession. New problems must be met with answers which address the present conditions and not those of a distant past.

My colleague Henry Reuss from Wisconsin, the Chairman of this Committee, is leaving Congress after 28 years.

He has been one of the most innovative, creative, constructive, and compassionate Members of Congress in every one of those years. He is an example of a man with a fine mind, a contagious personality, and great strength of personal character. His Chairmanship of the Committee and his leadership this year in producing the hearings on which this Report is based illustrates those amazing traits. The citizens of the 5th District and the entire State of Wisconsin, as well as the American people, have been served nobly by Henry Reuss who, year in and year out, put the best interest of the American people at the head of his agenda.

William Proxmire.

Republican Views
on the
February 1982 Economic Report
# of the President

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CHAPTER I. THE OUTLOOK FOR 1982

The Republican Members of the Joint Economic Committee are optimistic about the prospects for the national economy in 1982. We believe in the fundamental soundness of the Reagan economic program and are confident in its success. We reject calls for a change in direction, for tax increases, or a return to the worn-out Keynesian economic policies which got us into the current economic mess. We recommend continuation and enhancement of the program which is already in place. In particular, we recommend:

1. Further efforts to reduce the Federal budget deficit by additional spending reductions, not by tax increases;
2. Consideration of additional tax measures aimed at increasing saving, investment, and productivity;
3. Redoubled efforts to eliminate and reform excessively burdensome Federal regulations; and
4. Most importantly, a renewed commitment by the Federal Reserve to maintain a steady, consistent, noninflationary monetary policy.

Although the economy is currently in a recession, with unemployment rising and continued high interest rates, we believe it is critical to remember that the Reagan economic program was not enacted as a short-term, countercyclical program, but rather as part of a long-range strategy to reduce inflation and increase productivity, real economic growth, international competitiveness and real standards of living. We support President Reagan's rejection of economic tinkering in response to short-run economic developments. He believes, and we agree, that such policies have in the past created instability, inflation, and false expectations which are at the root of our current economic problems. With the severe limitations of economic forecasting, the actions of economic variables outside our control (such as OPEC), and the notable lack of success of past countercyclical efforts, we believe that the proper role of government economic policy is to foster a climate of long-run stability and noninflationary growth. The Reagan program meets this criterion.

It must be remembered that President Reagan inherited an economy which was not only moving into a recession, but one which had been in secular decline for some years. As Table I.1 illustrates, our Nation's rate of real GNP growth—the most basic measure of economic well-being—has declined from a rate of 4.3 percent per year from 1959 to 1965, to 4 percent from 1965 to 1969, to 3.6 percent from 1969 to 1973, to 2.8 percent from 1973 to 1979. There has been virtually zero growth since 1979. There has also been a sharp decline in national productivity, which translates directly into lower standards of living. Table I.2 indicates how poorly the U.S. has done in comparison to other industrialized countries, and Table I.3 graphically illustrates how the decline in productivity and GNP growth has lowered living standards, in terms of weekly earnings. As one can see, in terms of real gross weekly earnings, and especially in terms of real spendable weekly earnings, American workers are much worse off today than they were ten years ago.

TABLE I–1. REAL GNP, TOTAL FACTOR PRODUCTIVITY, AND FACTOR INPUTS

[Average annual growth rates, 1959–79]

Period	Real GNP	Total factor productivity	Capital	Labor
Total GNP				
1959 to 1965	4.3	2.5	3.8	0.9
1965 to 1969	4.0	1.9	4.1	1.2
1969 to 1973	3.6	2.3	3.5	0.4
1973 to 1979	2.8	1.2	2.5	1.6
Private nonfarm nonhousing GNP				
1959 to 1965	4.4	2.5	4.1	1.0
1965 to 1969	4.0	1.3	5.8	1.3
1969 to 1973	4.1	2.4	4.2	0.7
1973 to 1979	2.8	0.6	3.2	1.8

Sources: Department of Commerce (Bureau of Economic Analysis), Gollop, Frank and Jorgenson, Dale, "U.S. Productivity Growth By Industry 1947–1973"; and Council of Economic Advisers.

TABLE I–2. GNP PER EMPLOYED WORKER IN MAJOR INDUSTRIAL COUNTRIES

[Percent change per year, 1963 to 1979]

Country	1963 to 1973	1973 to 1979[1]
United States	1.9	0.1
Japan	8.7	3.4
Germany	4.6	3.2
France	4.6	2.7
United Kingdom	3.0	0.3
Italy	5.4	1.6
Canada	2.4	0.4

[1] Estimate.

Source: Organization for Economic Cooperation and Development.

TABLE I–3. GROSS SPENDABLE WEEKLY EARNINGS IN CURRENT AND 1977 DOLLARS

Year and month	Gross average weekly earnings		Spendable average weekly earnings			
			Worker with no dependents		Married worker with 3 dependents	
	Current dollars	1977 dollars	Current dollars	1977 dollars	Current dollars	1977 dollars
1971	127.31	190.58	103.80	155.39	112.43	168.31
1972	136.90	198.41	112.19	162.59	121.68	167.35
1973	145.39	198.35	117.51	160.31	127.38	173.78
1974	154.76	190.12	124.37	152.79	134.61	165.37
1975	163.53	184.16	132.49	149.20	145.65	164.02
1976	175.45	186.85	143.30	152.61	155.87	166.00
1977	189.00	189.00	155.19	155.19	169.93	169.93
1978	203.70	189.31	165.39	153.71	180.71	167.95
1979	219.91	183.41	178.00	148.46	194.82	162.49
1980	235.10	172.74	188.82	138.74	206.06	151.65

Source: Department of Labor, Bureau of Labor Statistics.

The President's economic program was designed to alter these trends by increasing the reward for work, saving, and investment, by reducing tax and regulatory barriers to production, by reducing government's command of private sector resources, and by stopping inflation. Inflation has abated, short-term interest rates are well below the level in January 1981, the growth of government spending has been greatly reduced, and government spending, taxes and the deficit are all declining as a share of GNP. (See Tables I.4 and I.5.)

TABLE I–4. INFLATION AND INTEREST RATES

[Percent]

Year	Change in CPI	Average Treasury bill rate
1977	6.8	5.3
1978	9.0	7.2
1979	13.3	10.0
1980	12.4	11.5
1981	8.9	14.1
1981:		
January	.7	14.7
February	1.0	14.9
March	.6	13.5
April	.4	13.6
May	.7	16.3
June	.7	14.6
July	1.2	14.7
August	.8	15.6
September	1.2	15.0
October	.4	13.9
November	.5	11.3
December	.4	10.9

Source: Bureau of Labor Statistics and Department of Treasury.

TABLE I–5. FEDERAL BUDGET TRENDS

[Percent]

Fiscal year	Growth in Outlays	Share of GNP		
		Outlays[1]	Receipts	Deficit[1]
1980	17.4	23.0	20.1	2.9
1981	14.0	23.7	21.0	2.8
1982	10.4	24.2	20.3	3.8
1983	4.5	22.5	19.4	3.1

[1] Including off-budget entities.

Source: Office of Management and Budget.

Although we must see progress in reducing the size of the federal deficit—in absolute terms as well as share of GNP—we strongly oppose efforts to achieve this goal by reducing the size of the scheduled tax cut. It the first place, it would do little to accomplish this goal, since the increase in budget receipts from delay of the tax cut would offset only a small fraction of the estimated deficit—and this assumes current economic growth trends which would certainly be lower if the tax cut were delayed. Secondly, the personal tax cut barely offsets the tax increases taking place simultaneously, as the result of bracket-creep and social security. Thus any reduction in the size of the personal tax cut constitutes a significant tax increase and a serious hardship for all taxpayers. (See Tables I.6 and I.7.)

TABLE I–6. GROWTH IN FEDERAL BUDGET RECEIPTS

[Billions of dollars]

	1982	1983	1984	1985
Under existing law, administrative actions and proposed legislation	27.5	39.4	56.9	73.6
Under tax rates and structure in effect January 1, 1980	56.5	75.1	90.4	91.7
Difference	29.0	35.7	33.5	18.1

Source: Office of Management and Budget.

TABLE 1–7. FACTORS AFFECTING PAYMENT OF PERSONAL INCOME TAXES

[In billions of dollars]

	Increase			Tax cuts [2]	Personal net change
	Social Security [1]	Bracket creep	Total		
Calendar year:					
1981	6	13	19	−4	15
1982	13	28	41	−41	0
1983	19	53	72	−84	−12
1984	26	77	103	−116	−13

[1] Increase in tax rates plus increase in base above that consistent with growth of incomes.
[2] Rate reductions and reduction of marriage penalty.

Source: Department of Treasury, Office of Tax Analysis.

We know of no school of economic thought which argues that taxes ought to be increased during a recession or as a means of increasing economic growth. We believe that the best way to reduce the deficit is to encourage economic growth over the long term, and the recently enacted tax cut is the best means we have for accomplishing that goal. At the same time, we are gravely concerned that individual Americans not be called upon to sacrifice well being for the sake of long-term goals. While further budget cuts are necessary, we must take account of the truly needy.

Those who propose that significant tax cuts be taken away in the hope of using these tax increases to balance the budget have forgotten recent experiences. From fiscal year 1976 to fiscal year 1981, the tax burden on the people of this country increased by $300 billion. What was the effect on the deficit of this doubling of the tax burden during these years? Deficits totalled over $300 billion during this five-year time period, and the fiscal year 1981 deficit of $57.9 billion was only $8.5 billion less than the fiscal year 1976 deficit. What was the effect of this $300 billion tax increase on economic growth? Economic growth declined every year from fiscal year 1977 to fiscal year 1980, and in 1981 we had a meager 1.9 percent increase in real GNP.

The message is clear. If the large portion of the stimulative tax cuts—such as removal of the third year of the tax cut—are rescinded, we can look for slower economic recovery and larger deficits.

We do not defend deficits. We want a balanced budget. The Republicans on the Joint Economic Committee have for many years been concerned with the growing control over the economy by the Federal government, through higher and higher spending. We are compelled to point out, however, that some of the arguments surrounding deficits are without fact of evidence.

Chapter II.—THE 1968 TO 1980 MACROECONOMIC GAME PLAN AND THE MESS IT CREATED

The problems that afflicted our economy in 1981 did not emerge suddenly. They began 15 years ago. They are rooted in the macroeconomic game plan that evolved in the 1960's and dominated economic policy actions in the Administrations of Presidents Johnson, Nixon, and Carter. They will be cured by the policies of President Reagan's New Beginning.

THE GAME PLAN OF THE SIXTIES AND SEVENTIES

The macroeconomic game plan of the 1960's and 1970's had four elements. Each element had its own purpose.

Fiscal policy was used to manage aggregate demand. In theory, it was to be used symmetrically, providing stimulus when aggregate demand was faltering and restraint when the economy was overheating.

Monetary policy was used to manage interest rates. In theory, it was used to keep them low.

Incomes policy was used to guide, constrain, and even to control business and labor price and wage decisions. The purpose was to keep inflation in check.

And regulatory policy was used to achieve such varied goals as clean air, clean water, workplace safety, and lower energy prices.

The way things worked out, the plan did not succeed. Incomes policy failed to keep inflation in check. Monetary policy failed to prevent interest rates from rising as the years passed. Fiscal policy turned out to be one-sided. Fiscal stimulus was applied almost entirely through increased spending, even when restraint was called for—except in 1968 when restraint was applied via a tax increase, and then it did not work. In addition, tax and spending policies were used in ways that favored consumption and penalized saving, personal effort, and risk taking. And Federal regulations proved to be burdensome, impacting on investment, productivity, and economic growth.

To understand President Reagan's New Beginning and the problems and promise that lie ahead, it is useful to review briefly the evolution, history, and internal flaws of the disastrous fiscal, monetary, incomes, and regulatory policies of the 1960's and 1970's.

Evolution

Price and wage guideposts were first spelled out in 1962. They were aimed at preventing businesses and unions, which were perceived to have power to raise prices and wages, from doing so. As President Johnson explained in 1965, business and labor were given "a guide for sound noninflationary price and wage decisions." He later told the Nation, "I count on the sense of public responsibility of our labor leaders and our industrial leaders to do their full part to protect and extend our price stability."

It did not work. Despite some awesome jawboning by President Johnson, prices and wages began to creep up in 1965. This had nothing to do with "the sense of public responsibility of our labor leaders and our industrial leaders." Inflation, which had been stopped after World War II and again after the Korean War, was revived in the late 1960's by the combination of unrelenting fiscal stimulus and accommodative monetary policy. Incomes policy could not keep the inflationary momentum that these policies unleased in check.

Fiscal policy had been used to stimulate the economy in 1964, when the Kennedy tax cut was passed. By itself, the Kennedy tax cut would not have been inflationary. Indeed, it has welcome supply-side effects. However, the expenditures side of the budget became increasingly stimulative beginning in 1965 as spending for the Vietnam War and the Great Society accelerated. Worse, monetary policy was accommodative, adding extra stimulus. The growth rate of the exchange media measure of money (M1) was accelerated from 2.5 percent per year in 1961, 1962 and 1963 to 4.2 percent in 1964, 1965, 1966, and 1967. Thus, despite the price and wage guideposts and President Johnson's jawboning, inflation was born again. By 1968, it was clear that either fiscal policy or monetary policy, or both, would have to be used to fight inflation.

Unfortunately, the Johnson Administration made the wrong choice. It chose to use tax policy to do the job, while attempting to use monetary policy to keep interest rates down. As the Council of Economic Advisers said in their economic report in 1968, "After a hard look at the alternatives, it has been and remains the conviction of both the Administration and the Federal Reserve that the Nation should depend on fiscal policy, not monetary policy, to carry the main burden of the additional restraint on the growth of demand that now appears necessary for 1968."

To stop the emerging inflation, President Johnson proposed 10 percent surcharges on personal and corporate income taxes. Congress enacted them in June 1968. Monetary policy, however, remained expansive, putting the entire burden of restraint on fiscal policy. As stated by President Johnson, "the cost of monetary restraint is high and unfair, imposed on a single industry—homebuilding."

To carry out its assignment, the Federal Reserve accelerated money growth. It acted under the traditional Keynesian assumption that the creation of new money will decrease interest rates. Measured year on year, M1 money growth was increased from 3.9 percent in 1967 to 7.0 percent in 1968. In the second half of 1968, M1 growth averaged over 8.0 percent per year.

The result of the combination of tight fiscal and loose monetary policy of that time was very different than planned. Despite the tax surcharges which produced the equivalent in 1981 terms of a $70 billion decrease in the deficit, inflation was given a further boost and interest rates rose. Interest rates were higher by the end of 1968 than they were in June 1968 when the surtaxes were legislated.

In 1969, the incoming Nixon Administration temporarily departed from the game plan in order to fight inflation. Monetary restraint—true monetary restraint, the slowing of money growth—

was applied. The tax surcharges, which were scheduled to expire in June 1969, were extended. The growth of Federal spending was slowed. Incomes policy was forsworn. In time, inflation fell. Measured from four quarters earlier, inflation topped-out in the first quarter of 1970. However, before it did, the deceleration of money growth, together with the depressing effects of the surtaxes and the still accelerating inflation, which was raising producer costs and narrowing profit margins, had brought about a recession. That recession began late in 1969.

Early in 1970—ironically, just as slower money growth began to slow inflation—the Nixon Administration reactivated the Johnson game plan in order to fight recession. Monetary growth was accelerated. New fiscal stimulus was provided. Incomes policy was revived. In August 1971, a wage-price freeze was ordered and kept in place for 90 days when a comprehensive mandatory system of flexible controls was put in place.

Nixon's new policies appeared to be successful—at least in the short run. The recession ended late in 1971, and inflation continued to slow. However, the seeds of later destabilization had been planted.

In mid-1973, inflation was again seen as the economy's main problem, and once again money growth was slowed. Then, late in 1973 and early in 1974, OPEC raised the price of oil fourfold. Inflation and interest rates soared still higher. Money growth continued to decline and by the fall of 1974, buffetted by inflation and the initial effects of slowing money growth, which temporarily reduces output, the economy was deep in the throes of our worst recession since the 1930's. However, the worst was about over, at least for a while. The recession caused interest rates to plunge, beginning late in 1974, and slower money growth caused inflation to decelerate sharply, beginning in the spring of 1975. Economic recovery began in the spring of 1975.

In spite of OPEC's supply shock, and even though unemployment rose to a post World War II high in the spring of 1975, monetary growth was kept relatively low in 1974 and 1975. Measured year over year, it was 4.9 percent in 1974 and 4.6 percent in 1975. That laid the groundwork for sustained economic recovery.

In 1976, measured for the whole year from all of 1975, real GNP rose nearly 6 percent. Thanks to the moderation in money supply growth, that happened without inflation being rekindled or interest rates rising. In fact, at the end of 1976, inflation measured by the change in the GNP deflator from four quarters ago was only 4.7 percent, well below the 10.9 percent peak rise between the first quarter of 1974 and the first quarter of 1975 and substantially below the 7.7 percent increase between the fourth quarter of 1974 and 1975. And interest rates drifted irregularly down throughout 1975 and 1976. In December 1976, the 90-day Treasury bill rate was 4.4 percent, and the prime rate was 6.4 percent. However, defeat was soon snatched from the jaws of victory.

The same game plan that had ignited inflation, sent interest rates soaring, and made the economy extremely vulnerable to recession under Presidents Johnson and Nixon was tried anew by President Carter.

The Carter years were marked by spending increases from start to finish, a tax cut in 1978, rapid money growth—averaging nearly 8 percent a year from 1977 to 1980—and the use of incomes policy to contain inflation. As was the case under Presidents Johnson and Nixon, at first there was improvement. Real growth was substantially greater than normal in 1977 and 1978, and unemployment fell. In addition, there was a run on the dollar, gold soared, and devaluation on the currency occurred. However, the boom turned sour after 1978. Incomes policy could not contain the forces of inflation (which were being fed by rapid money growth). Inflation mounted steadily. The four-quarter rate of rise in the GNP deflator reached 6.1 percent at the end of 1977, 8.5 percent a year later, 8.1 percent at the end of 1979 and 9.8 percent at the end of 1980.

With inflation renewed, interest rates soared. The 90-day Treasury bill rate, for example, climbed from 4.4 percent in December 1976 to 6.1 percent a year later, to 9.0 percent in December 1978, to 12.1 percent in December 1979, and to 15.7 percent in December 1980.

With higher inflation and soaring interest rates, real growth declined: It fell to 1.7 percent in 1979 and in 1980 real GNP actually receded by 0.3 percent.

Inherent Flaws

This brief history of macroeconomic events from 1968 until now provides compelling lessons for present and future macroeconomic policy.

(1) Incomes policy does not work. In spite of the best efforts of Presidents Johnson, Nixon, and Carter to make them work, price and wage guideposts, and even controls, did not keep inflation in check. The wonder is that it should have been so widely believed that they would. Inflation is not a mechanical process in which wages and prices chase one another upward. True, inflationary wage and price increases can be triggered by all manner of supply shocks. However, such shocks will not produce a wage-price spiral unless household and business spending increases enough period after period to validate period-to-period increases in prices and wages. And that cannot happen unless money growth is increased enough period after period to accommodate continual increases in household and business spending at inflationary rates. The result is that prices ultimately end up being more or less where they would have been without the controls or guidelines.

(2) Tax increases are not an effective way of keeping inflation in check or interest rates down. That is the lesson of 1968, when the Johnson Administration imposed 10 percent surcharges on personal and corporate taxes precisely to cool off the overheating economy and keep interest rates from rising. It did not work. Inflation rose after the tax surcharges were adopted. The rate of rise of the GNP deflator increased from 4 percent in the year ending in second quarter of 1968 to 4.6 percent the following year, and 5.5 percent the year ending in the first quarter of 1970. Interest rates also rose. The 90-day Treasury bill rate averaged 5.9 percent in December 1968 versus 5.5 percent in June 1968 (5.3 percent in the first half of the year). Yields on Treasury issues with three to five

years to maturity averaged 6.0 percent in December versus 5.7 percent in June yields on taxable Treasury bonds rose from 5.2 percent in June to 5.7 percent in December. Interest rates continued to rise in 1969. The bill rate averaged 7.7 percent in December 1969, the three- to five-year yield averaged 8.0 percent and the bond yield averaged 6.8 percent.

The record from 1976 to 1979 provides additional evidence. During these years, the deficit fell primarily as a result of increased tax revenues from "bracket creep." At the same time, both interest rates and inflation increased significantly. The National Income Accounts deficit fell from $69 billion in 1975, to $53 billion in 1976, to $46 billion in 1977, to $29 billion in 1968, to $15 billion in 1979. In the same period, the 90-day Treasury bill rate (measured at year-end) first fell from 5.5 percent in 1975 to 4.4 percent in 1976 and then rose to 6.1 percent in 1977, to 9.1 percent in 1978 and to 12.1 percent in 1979. Other interest rates exhibited similar changes. The GNP deflator inflation rate (measured between fourth quarters) fell from 7.7 percent in 1975 to 4.7 percent in 1976 and then rose to 6.1 percent in 1977, to 8.5 percent in 1978 and 8.1 percent in 1979.

(3) Monetary policy should be aimed at curbing inflation and keeping it in check. It is no accident that inflation and interest rates accelerated after 1967. They did so because money growth was increased. From 1956 to 1967, yearly M1 money growth averaged 2.3 percent and the yearly increase in the GNP deflator averaged 2.2 percent. From 1967 to 1980, both rose at an annual rate of 6.4 percent. From 1977 to 1980, money growth averaged 7.5 percent and inflation averaged 7.7 percent.

(4) The fight against inflation requires patience, perserverance, and courage, especially in the conduct of monetary policy. Money growth is the sustenance of inflation. Inflation will endure as long as money growth exceeds the economy's long-run real growth potential. Courage is required to fight inflation because the initial effect of slowing down money growth is likely to be a slowdown in economic activity and real hardship for many people, although a proper fiscal policy can largely mitigate these effects. And it should be remembered that inflation too imposes many hardships, especially on the elderly and those of fixed incomes. Patience is required because it takes time for reduced money growth to reduce inflation. Perseverance is required because reaccelerating money growth will reignite inflation. Unfortunately, twice since 1968 defeat was snatched from the jaws of victory by abandoning the fight. Money growth was slowed in 1969. That triggered a recession starting in the fourth quarter of 1969. Then the Federal Reserve reversed course early in 1970 just as the 1969 deceleration in money growth started to reduce inflation.

Money growth was again slowed in mid-1973. The deceleration was sharp enough and kept in place long enough to dramatically reduce inflation. Between 1974 and 1976, the year-on-year rate dropped from nearly 10 percent to just over 5 percent. But the effort was not sustained. Year-on-year money growth was increased from under 5 percent in 1974 and 1975 to 5.6 percent in 1976, 7.5 percent in 1977, 8.2 percent in 1978, 7.8 percent in 1979, and 6.4

percent in 1980. As a result, inflation was reignited and surged to new post World War II highs.

In summary, from 1968 to 1980 the Federal Reserve produced roller coaster money growth superimposed on high average money growth. That, in turn, helped to produce stagflation—recessions in 1969-70, 1974-75, and 1979-80 and high and rising inflation. High money growth validated the inflation effects of supply-side shocks in 1973-74 and 1979-80 and converted the enormous budget deficits of the past 13 years into persistent and virulent inflation. The ultimate irony is that fast money growth did not keep interest rates down or financial markets calm. The volatility of financial markets increased and interest rates skyrocketed.

(5) Fiscal policy is a supply-side tool. In the 1968 to 1980 period, we tried to use tax and spending policies to improve the standard of life for the poor and disadvantaged. On balance, it did not work. True, there has been some improvement in their living standards. But there might have been more if we had focussed on increasing growth instead of on redistributing income.

Some of the spending programs that were put in place helped the poor and the disadvantaged. No one should deny that. But others did not. Even those that helped, sometimes provided assistance to persons other than the truly needy. No one should deny these facts either. Tax policies, on the other hand, definitely had perverse effects. The tax code was used to penalize saving, personal effort, and risk taking. Consequently, investment, productivity, and growth all suffered. The result is that we are still far from our goal of eliminating poverty.

(6) Finally, during the past 15 years, the Federal Government increasingly used regulations to channel private sector resources toward achieving such public goals as a cleaner environment, safer workplaces, less hazardous consumer products, and equal employment opportunities. Many of these programs produced substantial benefits. However, the cost of achieving laudable social goals on the private sector were not adequately considered in setting regulatory policy.

By the end of 1980, it was clear that it was time to change—time to dismantle all incomes policies; time to take a hard look at the costs as well as the benefits of government regulations; time to end those spending programs that do not improve the lot of the poor and to prune all programs so that only the truly needy are helped; time to revise the tax code to spur saving, personal effort, and risk taking; and time to conduct monetary policy to curb inflation and keep it in check. As discussed in the remainder of our Report, these changes are being implemented, and they are beginning to work. The most visible signs that they are working are that inflation and interest rates are topping out and the saving rate is bottoming. We are confident that in time the U.S. economy will pass from the unstable problem period we have been in to an era marked by price level stability, reasonable interest rates, sustainable growth, and full employment.

Chapter IIIA.—FISCAL POLICY, PART A: SPENDING

The rapid growth in the size of the Federal Government has had a crippling effect on growth in the U.S. economy. Federal spending is out of control. Unless strong remedial actions are taken to sharply reduce growth in this spending, the economy will continue to suffer from high real interest rates, sluggish economic growth and a less than optimal rate of capital formation. Also, the long-term policy of reducing poverty, labor market discrimination, and income inequality will be thwarted.

The Republican members of the JEC oppose short-run fiscal policy manipulations to achieve macroeconomic goals. Instead, the Congress would be wise to consider adopting a multiyear planning process designed to achieve two broad objectives. First, Federal spending growth ought to be limited until the share of GNP accounted for by the Federal Government declines from its present level of 23.5 percent to 19 percent or less. Second, although deficits are unavoidable during recessions, a long-term goal of narrowing the gap between expenditures and revenues ought to remain a firm commitment of long-run fiscal policy. Attempts to reduce the deficit by raising taxes should be resisted, since, as in the past, this would accelerate growth in government and reduce economic growth.

EXPENDITURE TRENDS

Table IIIA–1 presents trends in Federal budget outlays as a percent of GNP over the period 1965 through 1981. These budget outlays include outlays for national defense, nondefense spending, payments to individuals, net interest, and other outlays.

The trends in Federal spending since the initiation of the Great Society programs are striking. Federal spending has been increasing at a much faster pace than the economy. For example, total Federal outlays advanced by 455 percent and nominal GNP by 333 percent from 1965 to 1981. After correcting for inflation, real Federal outlays advanced by 98.3 percent. The result has been a pronounced secular rise in the ratio of total Federal outlays to GNP. In particular, total Federal outlays were about 23.0 percent of GNP in 1981, up from about 18.0 percent in 1965.

Unquestionably, the Great Society programs launched in the mid-1960's enlarged the share of the Nation's resources allocated by the Federal Government. Moreover, this trend will continue unless Congress takes strong action to control government spending, especially the so-called uncontrollable items.

The impact of the Great Society programs is even more evident in the shift in Federal spending priorities over time, especially from national defense to nondefense spending.

TABLE IIIA-1.—FEDERAL BUDGET OUTLAYS AND ITS COMPONENTS AS A PERCENT OF GNP

Year	Total outlays	National defense	Total nondefense	Payments to individuals	Net interest	All other
1965	18.0	7.2	10.8	4.9	1.3	4.6
1966	18.6	7.6	11.0	5.0	1.3	4.7
1967	20.3	8.8	11.5	5.5	1.3	4.6
1968	21.4	9.5	12.0	5.9	1.3	4.8
1969	20.2	8.7	11.4	6.1	1.4	4.0
1970	20.2	8.1	12.1	6.5	1.5	4.1
1971	20.4	7.3	13.0	7.6	1.4	4.0
1972	20.4	6.8	13.7	8.0	1.4	4.2
1973	19.6	6.0	13.7	8.2	1.4	4.1
1974	19.4	5.6	13.8	8.5	1.6	3.7
1975	21.9	5.8	16.1	10.2	1.6	4.4
1976	22.2	5.5	16.8	10.8	1.6	4.4
1977	21.5	5.2	16.3	10.3	1.6	4.3
1978	21.5	5.0	16.5	9.9	1.7	4.9
1979	20.9	5.0	15.9	9.7	1.8	4.4
1980	22.5	5.3	17.2	10.6	2.0	4.6
1981	23.0	5.6	17.4	11.1	2.4	3.9

Source: Office of Management and Budget, Council of Economic Advisers, and the Senate Budget Committee.

Table IIIA-2 shows the components of budget outlays expressed as a percent of total budget outlays. Defense spending in 1965 was $47.5 billion or 40 percent of total Federal outlays. By 1981, defense spending rose to $159.8 billion, but the share of Federal outlays devoted to national defense fell to 24.3 percent over the period.

Nondefense outlays have steadily risen from $71 billion in Fiscal Year 1965 to $497.4 billion in Fiscal Year 1981, a jump of about 600 percent. The seven-fold increase of nondefense spending since the mid-sixties reflects the profound shift in Federal budget priorities. In 1965, nondefense spending amounted to 60 percent of total Federal outlays, but by 1981 it increased to 76 percent. Moreover, nondefense spending increased from 10.8 percent of GNP in 1965 to 17.4 percent of GNP in 1981.

TABLE IIIA-2.—COMPONENTS OF FEDERAL BUDGET OUTLAYS AS A PERCENT OF TOTAL OUTLAYS

Year	National defense	Total nondefense	Payments to individuals	Net interest	All other
1965	40.1	60.0	27.3	7.3	25.4
1966	40.8	59.2	26.9	7.0	25.4
1967	43.3	56.7	27.3	6.5	22.8
1968	44.2	55.8	27.3	6.2	22.2
1969	43.2	56.8	30.1	6.9	19.8
1970	40.2	59.8	32.3	7.4	20.2
1971	36.1	63.9	37.4	7.0	19.5
1972	33.2	66.8	39.4	6.7	20.8
1973	30.3	69.7	41.6	7.0	21.0
1974	29.0	71.0	43.9	8.0	19.1
1975	26.4	73.6	46.4	7.2	20.1
1976	24.5	75.4	48.4	7.3	19.7
1977	24.3	75.7	48.0	7.5	20.2
1978	23.5	76.5	46.1	7.9	22.6
1979	24.0	76.0	46.3	8.7	21.0
1980	23.6	76.4	47.0	9.1	20.3
1981	24.3	75.7	48.2	10.5	17.1

Source: Office of Management and Budget

Nondefense spending includes payments to individuals, social service spending, grants to State and local governments, international affairs, net interest, and a number of other items. From Table IIIA-1 it is evident that exploding payments to individuals comprise most of the real increase in Federal spending since 1965. This category includes unemployment compensation, Federal employee retirement benefits, food stamps, housing subsidies, social security, medicare and medicaid, and other programs. These payments have jumped 880 percent since 1965. From 27 percent of total outlays in 1965, transfer payments had mushroomed to 48 percent of Federal outlays by Fiscal Year 1981.

Equally impressive is a comparison of transfer payments to GNP. Transfer payments jumped from 4.9 percent of GNP in 1965 to 11.1 percent in 1981. This exponential growth is the primary driving force behind such of the expansion in Federal spending.

A slightly different way to look at outlays is to compare total expenditures to spending on domestic services. Domestic services may be defined as income security, health and hospitals, education, public welfare, and housing and urban development. According to Professor Roger Freeman of the Hoover Institution, domestic service outlays in 1965 amounted to 40 percent of total expenditures, but by 1978 it was estimated that this figure exceeded 60 percent.

The rate of increase of nondefense spending accelerated during the Carter Administration. Overall, nondefense outlays increased from $275 billion in 1976 to $497 billion in 1981, a jump of 81 percent. Total transfer payments jumped from $177 billion to $317 billion, an increase of about 79 percent. Entitlements such as unemployment compensation, food stamps, and social security, jumped from $177 billion in 1965 to $304 billion in 1981, a rise of 72 percent, or about 13 percent annually.

The outlook for Federal outlays is much more promising than the trends in the past might indicate. The Reagan Administration is committed to expenditure restraint. Instead of the 15.7 percent average annual growth rate that prevailed between 1979 and 1981, the Administration has proposed limiting that to about 7 percent. Moreover, within this limit the allocation of funds may change; some programs such as entitlements will likely continue to grow, albeit at a slower rate, while other lower priority programs may be pruned or eliminated.

As a first step in the struggle to restrain spending increases, the Congress passed the Administration-supported Omnibus Reconciliation Act of 1981 (P.L. 97-35). This law reduces projected spending increases by about $35 billion in FY 1982, $44 billion in FY 1983, and $51.6 billion in 1984. Though this is considered by some to be a massive reduction in Federal outlays, expenditures will likely jump to $725 billion in FY 1982, $758 billion in FY 1983, and $806 billion in FY 1984, according to Administration estimates and taking into account budget cuts in the 1982 First Concurrent Resolution.

EXPENDITURE ISSUES

It would be a mistake to think that achieving expenditure restraint will be an easy task. Entitlement indexation may render current expenditure controls ineffective. Moreover, off-budget outlays and Federal credit activity are areas of rapid expenditure growth outside of the unified budget. As discussed below, each of these present unique problems in controlling government outlays.

One of the most difficult problems in restraining spending is the immense and growing amount and proportion of so-called "uncontrollable" outlays now outside the annual budget process. An expenditure is defined by the Office of Management and Budget (OMB) as uncontrollable if spending in any year is determined by existing law or obligation. Most uncontrollable spending is for entitlements, but it also includes outlays for prior year contracts and interest costs. In 1982, $545 billion, or 75 percent of outlays, will fall into the uncontrollable classification.

Of total nondefense outlays projected for 1982, 87 percent is classified as uncontrollable, compared to 37 percent of defense spending. Entitlement payments now absorb about two-thirds of nondefense outlays. An entitlement establishes a claim to Federal payments by any person meeting the eligibility criteria of the program. Most entitlement outlays are permanently authorized and automatically funded without annual appropriations. Some entitlements, such as food stamps, do require annual appropriations, but the recipient nonetheless has a legal right to the entitlement benefit. Thus, annual outlays for entitlements are hardly influenced by congressional or presidential actions in the short run but are automatically generated. Most entitlement outlays consist of transfer payments to individuals, the single fastest growing component of Federal spending since 1965.

Over the years, increases in eligibility, participation rates, and indexing adjustments have contributed to the explosion of entitlement outlays. It is clear that to limit the expansion of Federal spending, it is absolutely essential that the growth of entitlement programs be contained. The best way of doing this is by increasing economic growth. For example, the rise in unemployment in 1982 will increase outlays for unemployment programs (unemployment insurance, assistance payments, food stamps, etc.) by $8 billion. Sustainable economic growth will reduce these automatic outlays.

Attention should be paid to the problem of indexation of entitlements. Besides generating increases in outlays independent of the annual budget process, indexation can distort Federal budget priorities. By automatically boosting outlays for indexed programs, indexing may divert resources from other programs accorded higher budget priority, in effect, crowding them out. The problem is that no one can foresee what the CPI or other indices will be in future periods, so the allocation of Federal resources is to some degree variable, arbitrary, and irrational.

Currently about 30 percent of Federal outlays are tied to the Consumer Price Index. This index has been criticized over the last few years for overstating inflation. The General Accounting Office (GAO), the Congressional Budget Office (CBO), and many other sources have found that the overstatement of inflation by the CPI has cost the Federal Government billions annually in recent years. Consequently, reform of indexation has become a major topic in the effort to restrain increases in Federal spending.

What is needed is a method that reconciles the goals of indexation and budget control. Although few indices, including the CPI, will accurately measure inflation over the business cycle, perhaps for the purposes of public policy and continuity the CPI should be maintained in a modified form, at least in the short run. One modification of indexation which has been proposed would limit benefit increases or outlays to 75 percent of the increase in the CPI, or the CPI minus 3 percent, whichever is lower. Other indices that have been suggested include the PCE or real wage index. Another option is to allow the President to propose adjustment of all indexed programs subject to congressional review. Whatever the exact method, some revision is sorely needed if spending is to be brought under control.

OFF-BUDGET SPENDING

The view of trends in spending afforded by analysis of Federal budgets doesn't provide a totally accurate picture because of off-budget Federal outlays. The unified budget used since 1969 to measure Federal revenues and outlays excludes a number of Federal programs. Aside from expenditures by the U.S. Postal Service, most off-budget spending consists of Federal credit activities facilitated by off-budget entities, especially the Federal Financing Bank (FFB). It has been estimated that FFB operations in 1981 amounted to practically all of the $21.0 billion of off-budget outlays. In addition, privately owned, government-sponsored enterprises have become increasingly active in financial markets. However, their outlays are not considered governmental.

Table IIIA-3 shows the exponential growth of off-budget spending in recent years from nothing in 1972. The general upward trend reached a startling 48 percent increase between Fiscal Year 1980 and 1981. Evidently this mode of Federal spending is totally out of control.

TABLE IIIA-3.—COMPARISON OF OUTLAYS FOR THE FEDERAL BUDGET, OFF-BUDGET FEDERAL ENTITIES, AND GOVERNMENT-SPONSORED ENTERPRISES

[In billions of dollars]

Fiscal year	Federal Government			Government-sponsored enterprises
	Budget	Off-budget entities	Total	
1965	118.4		118.4	1.2
1966	134.7		134.7	1.9
1967	157.6		157.6	−2.9
1968	178.1		178.1	1.7
1969	183.6		183.6	4.3
1970	195.7		195.7	9.6
1971	210.2		210.2	*
1972	230.7		230.7	4.4
1973	245.6	0.1	245.7	11.4
1974	267.9	1.4	269.4	14.5
1975	324.2	8.1	332.3	7.0
1976	364.5	7.3	371.8	4.6
1977	400.5	8.7	409.2	9.7
1978	448.4	10.4	458.7	24.5
1979	491.0	12.5	503.5	25.9

TABLE IIIA-3.—COMPARISON OF OUTLAYS FOR THE FEDERAL BUDGET, OFF-BUDGET FEDERAL ENTITIES, AND GOVERNMENT-SPONSORED ENTERPRISES—Continued

[In billions of dollars]

Fiscal year	Federal Government			Government sponsored enterprises
	Budget	Off-budget entities	Total	
1980	576.7	14.2	590.9	25.3
1981	657.2	21.0	678.2	33.4

Source: Office of Management and Budget.

Off-budget spending causes a number of problems in accountability and political responsibility. Large increases in Federal outlays can occur without adequate congressional review or control. Budget priorities may become distorted and noneconomic projects encouraged. In short, the existence of off-budget spending can encourage marginal and special interest spending that would otherwise not be funded. Moreover, the true extent of Federal involvement in financial markets and the rest of the economy is significantly understated.

Federal credit activities consist primarily of on-budget agency direct loans and off-budget loan guarantees. Some would also consider the credit activities of quasi-public and government-sponsored enterprises to be a form of Federal credit. Most Federal credit activities are not included in the unified budget, although they contribute greatly to the extent of Federal direction of economic resources. While unified budget outlays have increased annually, about 12 percent since 1976, new Federal credit has exploded at the annual rate of 27 percent. The estimated total amount of Federal Government credit outstanding is about $558.9 billion. The relatively rapid rate of growth in Federal credit is probably a result of its freedom from annual scrutiny in the appropriations process. Table IIIA-4 shows the increase in Federal credit and its growing proportion of capital funds since 1972.

TABLE IIIA-4.—FEDERAL PARTICIPATION IN DOMESTIC CREDIT MARKETS

[Dollars in billions]

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Total funds advanced in U.S. credit markets	$151.9	$198.5	$186.7	$174.4	$241.5	$310.8	$378.9	$412.9	$342.5	$407.8
Advanced under Federal auspices	$22.0	$26.1	$25.5	$27.0	$26.9	$36.7	$58.4	$72.9	$79.9	$86.5
Direct loans:										
On-budget	$3.0	$0.9	$3.3	$5.8	$4.2	$2.6	$8.6	$6.0	$9.5	$5.2
Off-budget	$18.9	$16.6	$10.3	$8.6	$11.1	$13.5	$13.4	$25.2	$31.6	$28.0
Guaranteed loans		$16.6	$10.3	$8.6	$11.1	$13.5	$13.4	$25.2	$31.6	$28.0
Government sponsored enterprise loans	$0.1	$8.5	$11.2	$5.6	$4.9	$11.7	$25.2	$28.1	$24.1	$32.4

TABLE IIIA-4.—FEDERAL PARTICIPATION IN DOMESTIC CREDIT MARKETS—Continued

[Dollars in billions]

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Federal participation rate (percent)........	14.5	13.4	13.7	15.5	11.1	11.8	15.4	17.7	23.3	21.2

Source: Office of Management and Budget.

Federal credit, through concessionary interest rates and the credit standing of the U.S. Treasury, diverts scarce capital resources toward projects most favored by politically influential special interests. Because of the subsidization involved, the capital may be *allocated* on political rather than economic criteria. Thus, Federal credit activities amount to the public allocation of capital, a process which benefits favored borrowers at the expense of everyone else. This implies that capital will not be invested in its most efficient and optimal use, generating a misallocation of resources and slower growth.

The Federal Financing Bank facilitates Federal credit activities byb serving as a conduit to financial markets. Originally, the FFB was to consolidate the credit demands of Federal agencies by issuing FFB obiligations in financial markets and lending the proceeds to the lesser recognized agencies, thus minimizing interest costs. Unfortunately, almost immediately the FFB became reliant on the U.S. Treasury for all of its funds.

As a financial intermediary the FFB engages in three basic operations: purchase of agency debt, purchase of agency loans and loan assets, and purchase of loans guarantees. In performing these functions, however, FFB operations can obscure the flow of funds and effectively alter the character of purchased assets. For instance, through its purchases of on-budget direct loans the FFB can transform them into off-budget loans. Moreover, by buying loan guarantees directly from a Federal agency, the FFB can convert loan guarantees into off-budget direct loans. In fact, this is the fastest growing activity of the FFB. The $21 billion in FFB outlays during 1981 pushed outstanding FFB credit to an estimated $83 billion.

Starting in 1981 a nonbinding credit budget and control system was inserted in the budget. Total new Federal credit estimated FY 1982 is $143.4 billion, up from $133.7 billion in the previous year. The Administration is expected to push for reductions in the rate of increase in Fiscal Years 1983 through 1986.

The Impact of the Federal Government on the Economy

Republican members of the Joint Economic Committee believe that rapid growth of the Federal Government is adversely affecting growth in the private sector. Growth in real GNP slowed from 73.7 percent over the 1950–65 period to 59.2 percent over the 1965–80 period. At the same time, growth in real Federal outlays accelerated. Adjusted for inflation, Federal budget outlays increased by 82.8 percent over the 1950–65 period and by 98.3 percent over the

1965–80 period. If off-budget outlays are included, the results would be even more dramatic.

There are several reasons for the inverse relationship betweeen growth in government and growth in the private sector. First, growth in government occurs by extracting resoures from the private sector. The opportunity cost of more government is foregone private sector output. Growth in Federal bureaucracy and programs leaves fewer resources to the private sector. Second, the higher tax rates asssociated with growth in the size of government discourages saving, investment, and work effort. The result has been a decline in economic growth and a slowing of capital formation and technological progress.

Third, along with growth in the size of government has been a growth in political power and Federal bureaucracy. Government bureaus and agencies have extended their influence into many new areas of American life. One result has been growth in government regulations and burdensome paperwork, both of which have added to the direct and indirect cost of doing busines. A major indirect cost is the extended time delays in investment decisions, time delays that can significantly curtail capital formation during periods of high interest rates. Another result is that a greater share of the Nation's resources are being allocated directly and indirectly by government rather than through the marketplace. Milton Friedman has argued that this loss of economic freedom is the real cost of growth in government. In particular, the loss of economic freedom has been a significant factor in lessening the creativity and vitality of the Nation's economy. Entrepreneurship and risk-taking, the basis of economic expansion, are discouraged by the encroachment of government.

Finally, short-run fiscal and monetary policies have contributed to the long-run slowdown in the U.S. economy by adding to instability. Too little is known about the impact of discretionary manipulations in tax rates, expenditure levels, and the money supply on the economy to place much reliance on these tools to "fine tune" the economy. In fact, government fiscal and monetary policies have proven on balance to be more destabilizing than stabilizing, creating an environment that is not conducive to investment and capital formation. The end result has been stagflation (high unemployment, inflation, and interest rates, and sluggish economic growth), adding to upward pressure on growth in Federal outlays.

This analysis of Federal outlays has emphasized the impact of government spending on the economy, but the causation runs both ways; that is, changes in the economy also affect budget outlays and revenues. The two-way causality implies that changes in Federal Government tax and expenditure programs affect the economy, but changes in the economy feed back and influence revenues and expenditures of the Government. In particular, the progressive tax rates, the open-ended nature of entitlement programs, and indexation have greatly increased the sensitivity of the budget to changes in the economy.

As shown in Table IIIA–5, a 1 percent increase in the unemployment rate, other things equal, results in a $29 billion increase in the budget deficit. Outlays rise by $7 billion as a result of higher unemployment and welfare payments, and revenues decline by $22 billion due to the shrinking tax base. In general, a 1 percentage point increase in the unemployment rate is associated with a decline of about 3.5 percentage points in real GNP growth. Tax collections from income, profits, sales, and inventory decline as a result.

TABLE IIIA-5.—SENSITIVITY OF BUDGET OUTLAYS TO SELECTED ECONOMIC INDICATORS

[In billions of dollars]

Indicator	Outlays	Receipts	Deficit impact
Unemployment rate (1% increase)	7	−22	+29
Consumer Price Index (1% increase)	2	7	−5
Interest rate [1] (1% increase)	3	2	+1
Real GNP growth (1% reduction)	6	−13	+19

[1] Average interest rate on all new Government debt.

Soutce: Congressional Budget Office and Joint Economic Committee staff estimates.

The budget is also sensitive to the inflation rate. In general, due to bracket creep, a 1 percentage point increase in the inflation rate raises revenue more than expenditures, resulting in a positive impact on the deficit. Other things equal, expenditures rise by $2 billion and revenue by $7 billion as a result of a 1 percent increase in the inflation rate. The progressive income tax rate structure results in revenue rising faster than cost-of-living adjustments to Federal expenditures. The result would be a $5 billion reduction in the deficit.

The budget also moves cyclically with changes in interest rates. A 1 percentage point increase in the interest rate raises revenue by $2 billion and outlays by $3 billion, other things equal. Thus, the combined impact results in a net increase in the deficit of $1 billion.

The impact of a reduction in the growth in real GNP of 1 percentage point would increase Federal outlays by $6 billion and receipts would fall by $13 billion, resulting in a net increase in the deficit of $19 billion. Of course, a reduction in the growth of real GNP mirrors a rise in the unemployment rate, but the correspondence is not one to one, resulting in different estimates of the budgetary impacts.

The complexity of the interrelationships between the economy and the budget is compounded when interdependencies among the economic indicators that influence the budget are taken into account. Inflation, interest rates, and unemployment are themselves interdependent. For example, inflation and interest rates generally move up and down together in a procyclical manner, whereas the unemployment rate often falls during expansions and rises during contractions. Recently however, inflation, interest rates, and unemployment have all risen together, creating a condition called stagflation. The upshot of this is that the budget outlook will be very sensitive to the economic assumptions underlying the forecast.

Interestingly, when the interdependence among the economic indicators is taken into account, the impact of inflation on budgetary expansion and expenditure growth is magnified. Inflation results in higher nominal interest rates and can lead to an inflationary recession with the unemployment rate rising. As we have seen, high inflation, high interest rates, and high unemployment all contribute to expenditure growth. Moreover, inflation increases revenue by more than it increases expenditures, allowing the expenditures to be financed without raising taxes, even when tax rates are reduced somewhat.

Unquestionably, the interdependence between inflation, interest rates, and unemployment greatly magnifies the importance of inflation as a determinant of expenditure growth. Thus, it would appear that controlling inflation by sound monetary management is a major factor in reducing growth of Federal expenditures. However, reducing Federal spending growth, deficits, and off-budget borrowing will certainly aid in the maintenance of a noninflationary monetary policy.

Some politicians and economists favor a balanced budget amendment to the U.S. Constitution that would require Congress to adjust taxes and expenditures to keep the budget in balance each year. They argue that budget deficits drive a wedge between the perceived cost of government programs and their actual cost to the taxpayer. Although future tax liabilities rise as a result of deficit spending, the increase is not perceived by the current taxpayer, creating a "fiscal illusion." Economists also point to inflation as a hidden tax that further contributes to the "fiscal illusion" of the public, since the financing of public services is generally not associated with inflation. For these reasons, the public's demand for public services is overstated, creating excessive growth in government. Thus, a balanced budget amendment would correct this institutional deficiency, by forcing the costs and benefits of spending to be considered simultaneously, and would halt the exesssive growth in government.

This proposal has merit in terms of its intent—to stop inflation and reduce excessive growth in government, but its adoption could have some perverse effects. First, Federal deficits expand during recessions and decline during expansions. Balancing the budget when the economy is in a recession would require a combination of higher taxes or lower expenditures. The result would be a temporary reduction in the deficit, but the severity of the recession might be exacerbated. The ultimate result could be the reemergence of a deficit requiring still further procyclical fiscal adjustment.

Another problem with a balanced budget amendment is that it does not deal with the main factors behind growth in government, such as inflation, liberal spending attitudes, and the behavior of the Federal bureaucracy. For example, a balanced budget amendment, if enacted by Congress, would not end inflation. Inflation is caused by excessive monetary growth. And monetary growth can be inflationary regardless of whether the Federal budget is balanced or not.

Third, the "fiscal illusion" concept constructed to provide a rationale for the balanced budget amendment is itself faulty. Professor Robert Barro, for example, suggests that the public views expenditures financed by deficits or taxes as similar, since deficits represent future tax liabilities. Thus, deficit finance cannot add to alterations in the public's preferences for public and private goods, destroying the notion of a "fiscal illusion." Consequently, according to Barro, public deficits do not create a bias toward public expenditures at the expense of public consumption.

Another prominent view places much of the blame for growth in government on the self-interest behavior of government bureaucrats and agencies. Professor Paul Craig Roberts, for example, argues that Federal bureaucracies and agencies have a perverse incentive system. Promotions and salary increases are based upon agency size, rather than productivity, leading to a proliferation of new programs, resistance to eliminating old programs, and fattened budget requests. Moreover, according to this view, there is a lack of executive and congressional surveillance of agency programs and budgets. The net result is a great deal of waste, fraud, and abuse in government, and an excessive growth in government spending.

We believe the solution to controlling growth in government is to reform the incentive system within the Federal bureaucracy and to increase efforts to monitor agencies to achieve greater fiscal responsibility. Proposals to link salary increases and the promotion of bureaucrats to cost reductions and to increase interagency competition are typical of this view. Also, some proponents of this view advocate setting up special "watchdog" committees to oversee agency budgets and program developments.

The proposal to improve surveillance and monitoring of agency actions and programs has a great deal of merit. The proposal to link salary increases and promotions to productivity, as measured by cost reductions, ought to receive the support of Congress. Also, all programs, new or old, ought to be carefully screened to determine their net worth to society. The adoption of these proposals would potentially save billions of dollars for the taxpayer and increase government efficiency, but their adoption would not significantly reduce growth in government attributable to economic stagnation—high inflation, unemployment, and interest rates—and the emerging military priorities.

RECOMMENDATIONS

Congress must take direct action to limit Federal spending and control growth in the size of government. The following are some recommendations that Congress should consider.

(1) Serious study should be given to implementing a multiyear budget cycle for budget resolutions along with authorization and appropriations legislation. Each budget cycle could be initiated with a binding budget resolution applied to the next few years. Furthermore, instead of 13 separate appropriation bills, all might be rolled into one omnibus appropriations bill to be passed in the first year of the cycle.

A multiyear cycle would provide enough time for smoother and more deliberate consideration of budget and spending measures. As illustrated by the Table III.A.6 below, in recent years Congress has missed budget resolution deadlines by generally large margins, particularly the binding second resolutions.

TABLE IIIA-6.—CONGRESSIONAL ACTION ON BUDGET RESOLUTIONS

Fiscal year	Date 1st resolution adopted	Days' lag after May 15, deadline	Date 2d resolution adopted	Days' lag after September 15, deadline
1977	May 13, 1976	0	Sept. 16, 1976	1
1978	May 17, 1977	2	Sept. 15, 1977	0
1979	May 17, 1977	2	Sept. 23, 1978	8
1980	May 24, 1979	9	Nov. 28, 1979	74
1981	June 12, 1980	28	Nov. 20, 1980	66
1982	May 21, 1981	6	Dec. 10, 1981	86

Source: Congressional Research Service

This tendency, along with the delay recently experienced with enactment of the 13 appropriations bills, has greatly disrupted the budget process. The consolidation of appropriations measures into one omnibus bill would be quicker, while facilitating more internal consistency in setting long-term priorities.

Multiyear budgeting would have the additional advantage of focusing attention away from short-run stabilization objectives to long-run fiscal objectives. For example, Congress might adopt multiyear planning targets focused on achieving a desired ratio of government expenditures to GNP over the planning horizon. Year-to-year deviations would be tolerated as long as they are justified by economic circumstances or national priorities. The Congress would issue new spending directives consistent with the revised spending plans.

The adoption of two long-run fiscal objectives are strongly recommended. First, growth in Federal expenditures ought to be less than growth in nominal GNP until Federal outlays relative to GNP falls from its current level of over 23 percent to 19 percent or less. Second, reduction in Federal deficits must be a firm long-run goal of fiscal policy. The acceptance of these long-run objectives must be accompanied by a commitment to reduce the budget deficits primarily by reducing growth in Federal outlays, not by raising taxes.

(2) Another possible reform would be to amend the budget act to allow the President to rescind appropriated funds subject to congressional disapproval—a line item veto. Currently, exercise of the President's recission authority must be specifically approved by acts of each house of Congress. Thus, a President's efforts to save money can be frustrated unless Congress acts with a resolution of approval within 45 days of notification. The present institutional arrangement tends to favor increase spending; but revision of the Budget Act to allow presidential recission unless rejected by Congress would change this. Under this reform, the onus would be on Congress to vote for or against each effort at spending restraint.

(3) As evidenced in Table IIIA-2, interest charges on the national debt have steadily grown to about 10 percent of the Federal budget. At high interest rates the issuance of long-term Federal debt is expensive and also undermines the credibility of the President's program to lower inflationary expectations. Consequently, we recommend that the Federal Government curtail the issuance of long-term debt until interest rates drop considerably.

If issuance of long-term debt were necessary for efficient debt management, we suggest that two alternatives be explored. One possibility would be to index the interest rates of the securities to some measure of inflation. Another idea would be to float low interest securities with gold clauses. Such bonds could save the Treasury billions of dollars over the next few decades.

(4) Finally, although Federal bureaucracy may or may not be a major cause of expenditures growth, it is nonetheless a contributing factor. The incentive for Federal bureaus and agencies to expand staff and budgets needs to be reversed. We strongly recommend that the Congress study and adopt measures to reward cost-cutting and productivity-enhancing actions within the Federal bureaucracy.

The adoption of these specific measures would provide the Congress with important tools to constrain growth in Fedeal outlays. However, unless the underlying economic conditions that lead to growth in government are reversed, strong pressures to expand Federal outlays will continue. Inflation, high interest rates, and sluggish economic growth (i.e., high unemployment) provide upward pressure on Federal outlays. Only by persistence in sound monetary management will inflation continue to subside. The expenditure controls recommended in the study offer no substitute for a sound economy in getting growth in Federal outlays under control.

Chapter IIIB. FISCAL POLICY, PART B: TAXATION

The Economic Recovery Tax Act of 1981 was probably the most significant economic policy development in many decades. By some indicators, the 1981 tax cut was the largest since imposition of the Federal income tax in 1913. The Mellon tax cuts of the 1920's involved proportionally larger cuts in marginal tax rates but were instituted in several acts of legislation passed over several years; moreover, a large part of the population at that time paid no taxes and were thus unaffected. The Kennedy tax cut (1964–1965) was about the same magnitude in terms of percentage reductions in marginal tax rates, but, again, was less momentous than the Reagan tax cut in that the personal income tax absorbed less of national personal income in the mid-1960's than is true today. Many years of inflation-caused "bracket creep" have raised tax rates since the mid-60's for nearly all Americans.

Though the magnitude and the percentage of the population affected by the tax cuts were large by historical standards, the most important impact of the tax cuts was that it changed the philosophy by which government taxes the economy.

Many earlier tax cuts viewed largely as attempts to stimulate aggregate demand to overcome a recession. Typically these attempts to stimulate demand also tried to redistribute national income. Tax rebates, increases in the standard deductions and personal exemptions, and other tax instruments that provide more tax relief to lower income individuals than to middle- and upper-income taxpayers were commonplace in the tax cuts over the past 15 years.

On the other hand, the 1981 bill was viewed by the Reagan Administration as a stimulus to long-term economic growth of the economy rather than as a "quick fix" to solve a short-run downturn in the economy. This sustained growth would be achieved, the Administration argued, predominantly by adopting tax changes that led to an increase in the supply of goods in the economy relative to the supply of money. In addition, the 1981 tax cut was "across the board" in nature and therefore reduced all taxpayers' tax bills by the same percentage.

Therefore, the tax cuts provided a strong signal that the Reagan Administration would try to construct a tax system that would stimulate economic growth rather than a tax system aimed at taking money from one group of taxpayers and giving it to another group of taxpayers.

The Economic Recovery Tax Act (ERTA) materially reduced the disincentive effects of high taxation on productive endeavors, increasing the rate of return of investments on both physical and human capital. The reduction in marginal tax rates by roughly 23 percent promised taxpayers of all walks of life considerable relief by substantially reducing the tax on additions to income. In addition, the reduction in marginal tax rates also caused a reduction in capital gains taxes. This reduction should stimulate capital markets by reducing capital immobility imposed by the tax code. The 10-5-3 depreciation allowance provided relief and correction for the devastating impact of inflation on the replacement cost of capital goods.

A key element of the Administration's economic plan is the stimulation of national savings. The tax bill's intent to encourage savings was positively promoted by liberalized rules regarding individual retirement accounts. In addition, the changes in depreciation will increase retained earnings which are, by definition, savings. Furthermore, reducing the top tax bracket on savings income from 70 to 50 percent will do much to increase savings from those income groups that do most of the country's saving. Lastly, beginning in 1985, the 1981 Tax Act will allow individuals to exclude 15 percent of interest received, up to $3,000, net of interest paid (other than mortage interest). On the other hand, the provisions permitting tax-free "all savers" certificates had a distinctly less stimulative effect on the level of national savings.

While the 1981 tax cut passed by Congress was on balance a very positive development, it is not as large a tax cut as was initially presented by the Administration. The amount of the reduction in marginal tax rates was cut back (from 30 to 23 percent), and the start of the cuts was delayed. The effect of congressional action was to lower the size of the 1981 marginal tax rate cut substantially. Thus the stimulative impact of the cut will become apparent only in 1982 and not fully apparent until 1983 and later.

Moreover, given the persistence of inflation—albeit at a more moderate rate than in the last two years—the phenomenon of "bracket creep" will lower the real size of the tax cut dramatically Indeed, the percentage of income going to Federal taxes rose in 1981 because the 5 percent tax cut on October 1 amounted to a mere 1.25 percent cut for the year 1981 as a whole, which was more than offset by the impact of higher tax rates associated with inflation-related increases in nominal incomes.

The real tax cut over the next three years will vary sharply with the assumptions one makes about the rate of inflation. Reductions in inflation will increase the real magnitude of the cut, which will extend the duration of the economic expansion. As is detailed in the monetary policy section of this report, the action of the Federal Reserve Board to follow a noninflationary money growth program is crucial to the success of the tax cuts to bring about substantial real economic growth.

In this regard, perhaps the most important long-term benefit of the 1981 bill comes from the provision calling for the indexation of Federal income taxes beginning in 1985. The provision makes it mandatory that increased government spending either increase the deficit or be paid for by legislated tax increases. No longer will spending proponents be able to allow the hidden tax increases caused by bracket creep to finance harmful increases in spending.

Another important feature of the Economic Recovery Tax Act was the overdue reform of estate tax rates and credits. There is evidence that high estate taxes reduce incentives to save on the part of families wanting to pass on farms, businesses, or other assets of their children. The estate tax changes in 1981 will ultimately reduce these disincentive effects, although here again prolonged inflation can undo much of the good achieved in the 1981 bill.

INSUFFICIENCIES OF THE 1981 TAX ACT

Although the Economic Recovery Tax Act of 1981 (ERTA) was an extremely positive development of historic importance, it can be criticized for not going as far as initially contemplated in terms of reducing marginal tax rates. Because of inflation, the real tax reduction under the Act is more modest than was the case of the Kennedy tax cut. Some of the provisions added to the legislation to make it politically more palpable (e.g., the provision permitting the sale of tax credits, the "all savers" certificate) offer considerably less stimulus to the economy per dollar of revenue involved than would the alternative approach of offering larger marginal rate reductions.

Provisions to encourage savings were not as bold as would be desirable given the fact that the personal savings rate in the United States is less than half that of most other major industrial nations. In several rapidly growing nations, most notably Japan, there are substantial tax incentives for saving. Though the 1981 changes in the U.S. tax code will stimulate additional savings, we need a substantial increase in national savings to fuel an economic boom that will endure for many years.

Increased savings other things equal, will increase the supply of loanable funds and lower interest rates, leading to increased capital formation and long-run economic growth. In the short run, increased national saving will provide stimulus to the economy to counteract recessionary pressures by aiding depressed interest rate-sensitive industries such as capital goods, housings, and automobiles.

The precise short-run revenue effects on the U.S. Treasury of tax incentives for additions to saving are difficult to predict and depend on several factors, most notably the sensitivity of savings to tax incentives. It is certain, however, that any short-run impact on Federal deficits would not have economically severe deleterious effects for three reasons.

First, for tax incentives that apply on to additions to savings, the growth in Federal borrowing due to the tax change will be more than offset by the increase in the national savings pool. This occurs because the Government loses only a portion of each additional dollar of saving (equal to the individual marginal tax rate), but the entire dollar of additional saving goes for debt financing. A person in the 25 percent tax rate bracket would be placing in the credit market four times the amount of debt caused by his deduction for increments to saving. Thus the "crowding out" of private investments through the interest rate mechanism that is sometimes associated with rising deficits is not applicable here. In fact, a situation of "crowding in" would exist.

Second, because the deficit level has attracted much public attention, it is important to note that additions to savings should be viewed as a method to achieve a balanced budget and not a movement away from reduced government deficits. The channelling of savings into private investment should have the long-term impact of raising output because of enhanced capital formation; this, in turn, will increase incomes and tax receipts in the future, reducing and possibly eliminating any initial adverse budgetary impact.

Third, deficits themselves do not cause inflation, and the historical relationship between budget deficits and inflation rates is quite tenuous. Deficits can aggravate inflation only if they are financed by monentary expansion, something which need not and should not occur.[1] The need to offset this proposed tax reform with other new forms of revenue is also reduced if our recommendations calling for governmental expenditure restraints are adopted. Reduction in the rate of growth in government spending can permit us to finance tax reductions without increased Federal borrowing.

ENTERPRISE ZONES

Enterprise zones are intracity geographical areas that have experienced significant economic decline. In these zones, tax and regulatory burdens on economic activity would be significantly reduced in order to stimulate commerce and create jobs. The Administration is expected to propose the following provisions to Congress:

Non-refundable personal income tax credits for employees,

Employer tax credit on payroll and employer tax credit for the hiring of disadvantaged workers,

Additional investment tax credits for structures and equipment,

Elimination of capital gains on resale of property in the zone, and

More generous loss carryover privileges.

The Federal Government will provide tax and regulatory relief only if the local governments also provide significant reductions in their tax and regulatory burdens in the zones. The local efforts will result from the competition for designation. The Department of Housing and Urban Development will designate no more than 25 zones during each of the first three years after enactment of the enterprise zones legislation.

The linkage of local government "effort" to Federal Government "reward" is not a new concept. What is unique is that the enterprise zones concept encourages a local response beyond government. In other words, in addition to tax and regulatory relief, local efforts to gain designation may include marshalling of all local private sector resources that could aid revitalization of an economically depressed area. Examples of local incentives outside of tax and regulatory relief include improved access to financial markets, technical assistance to new businesses, and community efforts to provide such social support services as crime control and child care.

We hope that local governments will be given sufficient latitude in constructing their packages of inducements and will be encouraged to utilize their resources of the local private sector. Only in this way can the local governments be expected to propose the most workable and effective mix of incentives. After all, a goal of the enterprise zones concept is to reverse the trend of strict planning at the Federal level. The Joint Economic Committee held hearings on this subject in Atlanta, Los Angeles, and Toledo. The Committee studied free market efforts to solve the problems, in cooperation with government. For example, in Toledo, its prototype enterprise zone located in the Warren-Sherman area, the Committee saw firsthand how the total commitment of the resources of all sectors of the community—labor, government, banks, business, churches, neighborhood associations—are necessary to provide the slightest hope of revitalizing distressed areas. In particular, small businesses, which have been and will continue to be the major job generators in our economy, are in particular need of the incentives that localities can offer.

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[1] U.S. Congress, Joint Economic Committee, *Deficits: Their Impact on Inflation and Growth,* by Robert E. Weintraub, Joint Committee Print (Washington, D.C.: Government Printing Office, 1981).

This reliance on various types of private initiative is not an argument that tax and regulatory relief by local and Federal Government are unimportant to the economic development of distressed areas. On the contrary, JEC hearings on local and State economic development this past year showed that taxes and regulation are significant burdens. The areas which would be eligible for enterprise zones designation are so depressed that various types of local and Federal involvement are necessary to accomplish revitalization.

Finally, a tax incentive which has been put into effect in the British enterprise zones should be considered for implementation in American zones. Special deductions are allowed for contributions in amounts less than the equivalent of about $20,000 to small businesses less than three years old. The result has been the formation of many investment clubs, with individuals pooling their resources to help the establishment and expansion of small businesses. With this provision in effect in American enterprise zones, healthy numbers of small jobs-producing businesses should be established.

The proper focus should not be to attract businesses into zones, but to unleash entrepreneural abilities which already exist there. This would enable us to add to the Nation's economy rather than simply reallocate it by encouraging tax-paying businesses to relocate to areas where taxes are lower. In any event, the Nation's economy benefits from having formerly idle individuals involved in productive enterprise.

Chapter III-C. FISCAL POLICY, PART C: DEFICITS

At present, many financial analysts, the press, and Members of Congress are greatly concerned about the prospect of large budget deficits projected for the next few fiscal years. This concern has led some to suggest that taxes be raised to offset these looming deficits and, hopefully, calm financial markets and reduce inflation and high interest rates. The Republican Members of the Joint Economic Committee, however, reject this approach and oppose tax increases to offset short-run increases in deficit projections generated by recession. This does not mean that we are unconcerned about deficits; indeed we are, but we believe that they would be reduced and, ultimately, eliminated by expenditure control rather than by "revenue enhancement."

TRENDS IN DEFICIT FINANCE

The growth in Federal outlays has been accompanied by growth in the size of the public debt. Gross Federal debt increased from $323.2 billion in 1965 to approximately $1,003.9 billion in 1981. This 211 percent increase in gross Federal debt resulted from the Federal Government's well known proclivity to spend more money than it takes in through tax collections. Accumulated deficits over the 16-year period from 1965 to 1980 amounted to $413 billion.

What are the probabilities that in a given year the budget will be in balance? The historical record speaks for itself. The Federal Government was in the black in only one year since 1965 and in only nine years since 1930. Moreover, the deficit as a percent of GNP has been increasing. It averaged 1.02 percent of GNP from 1965 to 1970, 2.37 percent from 1975 to 1980, and is expected to rise to about 4 percent of GNP by 1984.

TABLE IIIC-1.—FEDERAL DEFICITS AS A PERCENT OF GNP AND TOTAL FEDERAL OUTLAYS

	Percent of GNP	Percent of Federal outlays
Fiscal year:		
1965	0.2	1.4
1966 [2]	0.5	2.8
1967 [1]	1.1	5.5
1968	3.0	14.1
1969	[3] (0.4)	[3] (1.7)
1970 [2]	0.3	1.4
1971 [1]	2.2	10.9
1972	2.1	10.1
1973	1.2	6.0
1974 [2]	0.3	1.8
1975 [1]	3.1	13.9
1976	4.0	18.2
1977	2.4	11.2
1978	2.3	10.9

TABLE III C-1.—FEDERAL DEFICITS AS A PERCENT OF GNP AND TOTAL FEDERAL OUTLAYS—Continued

	Percent of GNP	Percent of Federal outlays
1979 [2]	1.2	5.6
1980 [1]	2.3	10.3
1981	2.0	8.8

[1] Recession years.
[2] Peak year in economic activity.
[3] Surplus.

The proportion of total Federal outlays financed by deficits varies considerably from year to year. As can be seen from Table IIIC–1, the Federal deficit was 14.1 percent of Federal outlays in 1968, 1.8 percent in 1974, 18.2 percent in 1976, and 8.8 percent in 1981. On average, the Federal deficit was 4.4 percent of total Federal outlays in the last half of the 1960's and 9.0 percent in the 1970's (9.1 percent if 1980 and 1981 are included). Evidently, the willingness of politicians to turn to deficit finance is on the upswing. Thus, it would appear that since the size of the public debt is determined by deficits and surpluses in the budget, the rate of growth in the size of the public debt is also on the upswing.

The year-to-year variations in the Federal deficit as a percent of Federal outlays largely reflects cyclical patterns in the economy. In particular, the proportion of total Federal outlays financed by deficit spending rises during recessionary periods and falls during periods of economic growth. This cyclical pattern is shown in Table III C–1. It is quite clear that budget deficits as a percent of total Federal outlays are the highest during recession years and the lowest in peak years. This suggests that policies to stimulate economic growth, such as the recently enacted tax cuts, can do much to reduce the Federal Government's reliance on deficit spending in the long run.

Table IIIC–2 provides insight into the relationship of budget deficits to the state of the economy. The economy experienced three recessions since 1970, and in each case the budget deficit jumped substantially. The growth of the budget deficit by about $40.5 billion from 1974 to 1975 reflects the severity of the 1975 recession; whereas, the smaller increase of $20.2 billion in the 1970–71 recession and the $31.9 billion in the 1979–80 recession reflects the relatively mild nature of these recessions. On average, the budget deficit increased by $30.8 billion in the three recessionary periods of the 1970's.

TABLE III C–2.—SENSITIVITY OF FEDERAL DEFICIT TO RECESSIONS

[Change in millions of dollars, 1970–80]

	Receipts	Outlays	Deficits
Period:			
1970 to 1971	−5,351	14,837	20,188
1974 to 1975	16,055	56,531	40,466
1979 to 1980	54,110	35,978	31,869

Source: Office of Management and Budget.

Historically, Federal deficits have risen in recessionary periods because Federal receipts decline and Federal outlays increase. Indeed, this was the case in the 1970–71 recession which saw receipts fall by about $5.4 billion and outlays increase by about $14.8 billion, but this pattern may no longer hold. For example, receipts in the 1974–75 recession advanced by $16.1 billion and outlays rose by $56.5 billion. The Federal deficit jumped by $40.5 billion. A similar pattern was followed in the 1979–80 recession. Receipts jumped by $54.1 billion and outlays by an explosive $85.9 billion during that recession.

Double-digit inflation, high interest rates, and high unemployment account for the anomaly. As discussed earlier, inflation has a powerful impact on growth in Federal outlays, especially in a recession. Indexation of entitlement programs resulted in explosive growth and payments to individuals in the 1970–71, 1975–76, and 1979–80 recessions; however, inflation also contributed to growth in Federal outlays through "bracket creep" in the latter two recessions. Ironically, real tax rates were forced upward by inflationary pressures at a time when economic circumstances warranted reductions in the real tax burden, deepening the recession and adding to additional Federal outlays.[1]

In 1982, the U.S. economy is in another recession. Prior to going into the recession, the projected 1982 budget deficit was approximately $45 billion, but now it is expected to rise to $99 billion. Most of the 1982 deficit in excess of $45 billion is due to worsening in the economy. For example, fiscal year 1982 tax receipts will decline by $31 billion because of reduced business activity and rising unemployment. Federal outlays will rise by $8 billion because of recession-induced payments for unemployment insurance, food stamps, and other assistance. Thus the recession accounts for $39 billion of the $54 billion excess in the current-estimated $99 billion deficit and the earlier-estimated $45 billion deficit for 1982. The rest of the gap is accounted for by higher debt interest costs and reduced revenues resulting from rapidly declining inflation rates. True, reduced inflation lowers indexed entitlement outlays, but these outlays are more than offset by reduced revenues from inflation-swollen taxes.

EFFECTS OF DEFICIT FINANCING

Given that we have large Federal budget deficits and will continue to have them for some years into the future, it is important that we understand what the economic effects of deficits are. In particular, what are the effects of budget deficits on inflation and interest rates?

Briefly stated, in the short run, budget deficits are actually associated with low, not high, interest rates and inflation rates. This is a cyclical phenomenon, reflecting high revenues and a strong desire to invest during economic expansion and law revenues and poor investment prospects during recessions. (See Table IIIC–3.)

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[1] U.S. Congress, Joint Economic Committee, *Studies in Fiscal Policy: Paper No. 2 Indexing the Individual Income Tax For Inflation: will This Help to Stabilize the Economy?* by Thomas F. Dernburg, Joint Committee Print (Washington, D.C.: Government Printing Office, 1976).

TABLE IIIC-3.—DEFICITS, INFLATION, AND INTEREST RATES

[Calendar years, dollars in billions]

Calendar year	On-budget deficit	GNP	Deficit as percent of GNP	GNP deflator	3-mo T-bill rate (average)
1971	$25	$1,078	2.3	5.0	4.3
1972	17	1,186	1.4	4.2	4.1
1973	18	1,326	0.6	5.7	7.0
1974	11	1,434	0.8	8.7	7.9
1975	75	1,549	4.8	9.3	5.8
1976	56	1,718	3.3	5.2	5.0
1977	51	1,918	2.7	5.8	5.3
1978	44	2,156	2.0	7.3	7.2
1979	28	2,414	1.2	8.5	10.0
1980	68	2,626	2.6	9.0	11.5

Source: Department of Treasury.

Note.—The data in this table, showing calendar year figures, differ somewhat from data in other tables in this Chapter and in Chapter III.A, which are shown on a fiscal year basis.

Real interest rates are determined chiefly by the real rate of return (after taxes) on additional plant and equipment—that is, the inherent productivity of the additional investment goods firms buy with the money they borrow. On top of this "real" interest rate is an "inflation premium." On top of the inflation premium is a "risk premium," which can be specific to bonds of differing quality or be a general problem if uncertainty has been created by frequent policy changes and by wide swings in money growth, inflation, and interest rates in the recent past. Interest rates may change if technological advances alter the usefulness of additional units of capital, if the tax code alters the reward to the investor, if there is a change in inflation due to a change in money growth rates, or if there are renewed fears of a vacillating policy.

Deficits do not necessarily affect any of these items quickly or to a significant extent. In particular, the Federal Reserve is not required to monetize deficits and has often chosen not to do so in the past. Such steady behavior contributes to lower risk and uncertainty and has beneficial effects. The Administration opposes the monetization of budget deficits and supports the Federal Reserve's policy of monetary stability.

One reason the Federal Reserve can avoid monetizing deficits is the responsiveness of saving. A deficit may crowd out private borrowers because it absorbs private saving. However, a higher saving rate can cover a deficit while still leaving ample funds for a healthy level of investment and real growth. It is the health of the economy, not the deficit per se, that concerns all of us. It is important to put deficits into the context of the savings available to finance them.

Next year's projected deficit may seem substantial, and it certainly is. The private saving which will be absorbed by that deficit could be used to better purpose in private sector investment in plant, equipment, and housing. Every effort should be made to reduce that deficit target. Nonetheless, that deficit does not mean the same thing in terms of crowding out and pressure in the financial markets as it would have meant in the absence of the Economic Recovery Tax Act of 1981 (ERTA).

Tax reduction has an immediate and direct effect on private sector saving. Business tax reductions for 1982 will total more than $14 billion. This represents a $14 billion increase in business saving and, therefore, is money that it will not need to borrow from the financial markets. Personal tax reductions for 1982 will be $42 billion. Typically, a substantial portion of personal tax reductions is saved. It should be especially true under the incentive-oriented, pro-saving ERTA, which should promote a substantial reallocation of income from consumption to saving, adding perhaps $10 to $15 billion to saving above what would otherwise have occurred due to income growth alone.

The additional private sector saving of between $25 and $30 billion must be viewed as an offset to the projected 1982 deficit. These additional savings flows make the deficit that much easier to finance than a comparable deficit under the previous tax law.

U.S. budget deficits do not appear to be the primary reason for high interest rates. Our budget deficits are not large relative to those abroad or in terms of our own recent historical experience. Two measures of fiscal influence are shown in the following Table IIIC–4 for the Big Seven countries for 1979 and 1980. The table shows the ratio of the public sector budget deficit to total domestic output and the ratio of the level of public sector expenditures to gross domestic output. Note that the table includes State and local, as well as Federal, data. It is clear from the table that the performance of the United States on both measures has been better than others of the Big Seven. In terms of government spending, only Japan, where the private sector carries on many government-type functions, showed a smaller proportion of expenditures to GDP in 1980 than the United States. From the standpoint of the budget deficit as a proportion of GDP, only the French had a lower ratio than the United States in 1980.

TABLE IIIC–4.—GENERAL GOVERNMENT EXPENDITURES AND REVENUES OF THE BIG SEVEN

[Percent of gross domestic product]

Nation	Year	Total expenditures	Total revenues	Surplus or deficit (−)
Canada	1979	38.6	36.8	−1.8
	1980	40.1	37.8	−2.3
France	1979	45.4	44.8	−0.6
	1980	46.3	46.6	0.3
Germany	1979	45.6	42.7	−2.9
	1980	46.1	42.6	−3.5
Italy	1979	45.9	36.5	−9.4
	1980	45.6	37.7	−7.9
Japan	1979	31.3	26.6	−4.7
	1980	31.6	27.6	−4.0
United Kingdom	1979	42.4	39.1	−3.3
	1980	44.3	40.6	−3.7
United States	1979	31.2	31.7	0.5
	1980	33.1	31.9	−1.2

Note.—Data are for all government, including State and local; data are partly estimated for 1980.

It is also true that foreign countries have a higher rate of national savings. Other things being equal, this enables them to finance larger budget deficits with less upward pressure on interest rates.

Therefore, the encouragement of saving, as well as the reduction of the budget deficit, is an essential element of the Administration program.

Some observers concede that the deficit is modest relative to GNP but contend that it is alarmingly large relative to total savings and to the capacity of our credit markets. This is not the case.

There are roughly similar patterns of Federal deficits as a percent of GNP, total private saving (including internal financing by firms), and funds raised in U.S. credit markets (private saving less internal financing by firms). This is due to the fairly stable ration of saving to GNP, a ratio which has not swung violently over time.

Table IIIC–5 indicates the extent to which Federal budget deficits have eaten into the pool of private saving. (Private saving equals personal saving and business saving—which consists of capital consumption allowances and retained earnings.) During the last five years, deficits, including off-budget items, have averaged 17.4 percent of total private savings. The net drain of the savings pool by the Federal Government has been partially offset, starting in the latter part of the 1970's by positive net savings of State and local governments. (These are not reflected in the figures.)

TABLE IIIC–5.—FEDERAL GOVERNMENT ABSORPTION OF PRIVATE SAVING

[Dollars in billions]

Fiscal	Surplus or deficit		Gross private saving	Surplus or deficit as percent of gross private saving [1]	
	Unified budget	Including off-budget items		Unified budget	Including off-budget items
1965	−1.6	−1.6	112.0	−1.4	−1.4
1966	−3.8	−3.8	124.7	−3.0	−3.0
1967	−8.7	−8.7	134.0	−6.5	−6.5
1968	−25.2	−25.2	143.5	−17.6	−17.6
1969	+3.2	+3.2	139.8	+2.3	+2.3
1970	−2.8	−2.8	150.9	−1.9	−1.9
1971	−23.0	−23.0	171.0	−13.5	−13.5
1972	−23.4	−23.4	183.2	−12.8	−12.5
1973	−14.8	−14.9	206.7	−7.2	−7.2
1974	−4.7	−6.1	235.7	−2.0	−2.6
1975	−45.2	−53.2	253.4	−17.8	−21.0
1976	−66.4	−73.7	295.6	−22.5	−24.9
1977	−44.9	−53.6	310.0	−14.5	−17.3
1978	−48.8	−59.2	347.4	−14.0	−17.0
1979	−27.7	−40.2	392.2	−7.1	−10.2
1980	−59.6	−73.8	423.0	−14.1	−17.4

[1] A minus percent implies an offset to private spending.

Source: Department of Treasury.

Table IIIC–6 indicates the extent to which funds raised under Federal auspices have risen as a share of total funds raised in the nonfinancial sector of the U.S. economy. Federal on-budget and off-budget deficits, Federally guaranteed loans, as well as government-sponsored enterprise borrowing (e.g., FNMA, Sallie Mae, Federal Land Banks) are included. The ratio has risen recently but remains within the range of earlier experience. It does not provide an adequate explanation of the current height of interest rates.

TABLE IIIC-6.—FUNDS RAISED IN CREDIT MARKETS

[In billions of dollars]

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Total funds raised in U.S. credit markets	151.9	198.5	186.7	174.4	241.5	310.8	378.9	412.9	342.5	407.8
Raised under Federal auspices	39.1	46.5	24.2	64.8	98.1	79.0	93.9	80.7	123.5	142.1
Federal borrowing from public	19.4	19.3	3.0	50.9	82.9	53.5	59.1	33.6	70.5	79.3
Borrowing for guaranteed loans	18.9	16.6	10.3	8.6	11.1	13.5	13.4	25.2	31.6	28.0
Government-sponsored enterprise borrowing	.7	10.6	10.9	5.3	4.1	12.0	21.4	21.9	21.4	34.8
Federal participation rates	25.7	23.4	13.0	37.2	40.6	25.4	24.8	19.5	36.1	34.8

Source: Office of Management and Budget.

Interest rates are determined by the supply and demand for credit in credit markets. Credit demand declines during a recession as does the supply of credit. Interest rates decline since demand for credit generally declines relative to the supply of credit. Under these conditions, government demand for credit generally increases (deficits as a percent of total Federal outlays increase), while private demand for credit declines.

Overall, there is a general decline in total credit demand. As a result, Federal deficits act to keep interest rates from falling to a level that private credit demand would indicate. However, this does not cause crowding out in the credit market. Clearly, the higher-than-would-be interest rates discourage investment borrowing somewhat, but investment borrowing is down in the recession as a result of rising inventories and excess production capacity, hardly conditions to encourage new investments. The Federal deficit, by stimulating demand and reducing business inventories will reduce excess productive capacity and lead to a higher level of private investment. Thus, instead of discouraging private investment in a recession, the net effect of a Federal deficit is more likely to be a higher level of private investment.

Whether or not crowding out actually occurs is an empirical question. An examination of the factual evidence does not support the crowding out hypothesis. For example, the Federal deficit as a percent of total Federal outlays increased by 7.85 percent in the 1975 recession, but interest rates *declined* by 6.1 percent (see Table IIIC-3). Likewise, the inflation rate subsided instead of accelerating as the "crowding out" hypothesis suggests. Moreover, interest rates and the inflation rate began to increase in 1979 at a time when the Federal deficit was relatively small, again contradicting the crowding out hypothesis.

In general, the evidence against crowding out is overwhelming. A projected Federal deficit in the magnitude of $100 billion will not cause chaos in the credit markets, nor will it necessarily cause inflation and high interest rates. The real danger of Federal deficit spending is that it may forestall attempts to implement an effective system of expenditure controls.

THE DEBT BURDEN

The public debt has now soared above $1 trillion. A public debt of this magnitude conjures up fears of financial disaster and economic collapse—or if not total collapse, implied shifting of the tax burden from the current and past generations to future generations.

The problem of intergenerational shifting of the debt burden arises from the choice between taxation and debt finance. To most economists, there is no essential distinction between public debt and taxation. Debt finance represents a future tax liability that current taxpayers must consider in their saving decisions. Thus, aside from the possibility of reduced saving in the current period, there can be no intergenerational transfer of the public debt burden.

To be sure, the future generation will inherit a lower capital stock resulting from less saving in the current period, but the financial markets will operate in such a way that other real costs will be borne by the present generation. In other words, since the real resources (e.g., steel, raw materials, and energy) required to provide public services are withdrawn as the debt is incurred, the real cost is likewise incurred by the present generation, and the real burden borne concurrently.

From Table IIIC–7 it is clear that although increasing in absolute amounts, the national debt as a percentage of GNP has been declining over the last 15 years or so. Total national debt as a percentage of GNP has fallen from 49 percent in 1965 to about 35 percent in 1981. Overall, gross Federal debt expanded by 211 percent and GNP by 333 percent between 1965 and 1981.

TABLE IIIC–7.—COMPARISON OF TRENDS IN FEDERAL DEBT AND GROSS NATIONAL PRODUCT

[Dollar amounts in billions]

Fiscal year	Gross Federal debt	Debt outstanding, end of year				Gross national product	Gross Federal debt as percent of GNP	Publicly held debt as percent of GNP
		Federal Government accounts [1]	Held by the Public					
			Total	Federal Reserve System	Other			
1965	323.2	61.5	261.6	39.1	222.5	659.5	49	40
1966	329.5	64.8	264.7	42.2	222.5	724.1	46	37
1967	341.3	73.8	267.5	46.7	220.8	777.3	44	36
1968	369.8	79.1	290.6	52.2	238.4	831.3	45	35
1969	367.1	87.7	279.5	54.1	225.4	910.6	40	31
1970	382.6	97.7	284.9	57.7	227.2	968.8	39	29
1971	409.5	105.1	304.3	65.5	238.8	1,031.5	40	30
1972	437.3	113.6	323.8	71.4	252.3	1,128.8	39	29
1973	468.4	125.4	343.0	75.2	267.9	1,252.0	37	27
1974	486.2	140.2	346.1	80.6	265.4	1,379.4	35	25
1975	544.1	147.2	396.9	85.0	311.9	1,479.9	37	27
1976	631.9	151.6	480.3	94.7	385.6	1,640.1	39	29
1977	709.1	157.3	551.8	105.0	446.8	1,864.1	38	30
1978	780.4	169.5	610.9	115.5	495.5	2,083.8	35	29
1979	833.8	189.2	644.6	115.6	529.0	2,353.3	35	27
1980	914.3	199.2	715.1	120.8	594.3	2,567.5	36	28
1981	1,003.9	209.5	794.4	124.5	670.0	2,858.6	35	28

Source: Office of Management and Budget.

The declining ratio of publicly held dept to GNP implies that the real burden has fallen relative to the ability of the economy to sustain the debt. Thus, although the size of the Federal debt presents a variety of debt-management problems, growth in the Federal debt is no reason for alarm. Of course, we should not be sanguine about the size of the public debt. Most economists agree that debt financing is a logical way to finance capital projects when the benefits are spread over many years, but the financing of current expenditures by debt finance should be undertaken only when necessary to achieve long-run macroeconomic goals such as accelerated capital formation and economic growth.

As previously discussed, the ratio of the public debt to GNP has been declining, but interest payments on the public debt are another matter. Monetary policies pursued in recent years have increased interest rates by generating inflationary expectations and a high-risk premium. Consequently, although the ratio of national debt to GNP has fallen, interest on publicly held debt as a percentage of GNP has jumped from 1.49 percent in 1965 to 2.76 percent in 1981 (Table IIIC-8). In this same period, the share of the budget absorbed by these interest payments rose from 8.29 percent to 12.00 percent of total budget outlays, a significant rise considering how rapidly the budget has grown in that time.

TABLE IIIC-8.—COMPARISON OF TRENDS IN INTEREST ON FEDERAL DEBT

[Dollar amounts in billions]

Fiscal year	Interest on the gross Federal debt					Interest on debt held by public as percent of—	
			Paid to the public				
	Total	Federal Government accounts	Total	Federal Reserve	Other	GNP	Budget outlays
1965	11.8	2.0	9.8	1.4	8.4	1.49	8.29
1966	12.6	2.1	10.4	1.7	8.7	1.44	7.75
1967	14.2	2.6	11.6	2.0	9.6	1.50	7.39
1968	15.6	3.0	12.6	2.4	10.2	1.52	7.09
1969	17.6	3.5	14.1	2.9	11.2	1.55	7.70
1970	20.0	4.4	15.6	3.5	12.2	1.61	7.99
1971	21.6	.3	16.3	3.7	12.6	1.58	7.78
1972	22.5	5.8	16.6	3.7	12.9	1.47	7.20
1973	24.8	6.3	18.5	4.3	14.2	1.48	7.54
1974	30.0	7.7	22.4	5.5	16.9	1.62	8.35
1975	33.5	8.8	24.7	6.1	18.6	1.67	7.60
1976	37.7	9.0	28.7	6.3	22.5	1.75	7.89
1977	42.6	9.6	33.0	6.8	26.2	1.77	8.24
1978	49.3	10.2	39.2	8.0	31.2	1.88	8.73
1979	60.3	12.1	48.3	9.6	38.6	2.05	9.83
1980	75.2	14.8	60.4	12.5	47.9	2.35	10.48
1981	94.5	16.5	78.0	13.6	65.3	2.76	12.00

Source: Office of Management and Budget.

Although the real burden of the public debt must be borne by the current generation, principal repayment and interest burdens may be another matter. Some economists argue that the financial costs can be shifted forward to the future generations regardless of the absorption of real resource costs by the current generation. Other economists disagree for two reasons. First, to the extent that the Federal debt is internally held, payment of principal and interest on the public debt simply transfers income from the bondholding public to the nonbondholding public. Second, interest paid to Federal Government accounts and the Federal Reserve System, though rising rapidly, does not require higher future taxes, since interest payments are ultimately retained by Federal agencies or with the U.S. Treasury. What the government pays on the one hand, it receives on the other.

Of importance to the future interest burden is the increase in the proportion of the Federal debt owned by investors overseas. In 1965 only $12.3 billion, or 4.7 percent of the publicly held debt fell into this category. By 1980 this amount had expanded to $135.5 billion, or by 1,000 percent over just 17 years. Foreign and internationally owned debt now stands at about 17 percent of the publicly held debt. While gradually increasing after 1970, it grew especially rapidly after 1976. As shown in Table IIIC–9, it jumped 94 percent from the 1976 level of $69.8 billion to about $135.5 billion at the end of fiscal year 1981.

TABLE IIIC–9.—FOREIGN HOLDINGS OF FEDERAL DEBT

[In billions of dollars]

Fiscal year	Debt held by public		Borrowing from public		Interest on debt held by public	
	Total	Foreign	Total	Foreign	Total	Foreign
1965	261.6	12.3	4.1	0.3	9.8	0.5
1966	264.7	11.6	3.1	−.7	10.4	.5
1967	267.5	11.4	2.8	−.2	11.6	.6
1968	290.6	10.7	23.1	−.7	12.6	.7
1969	279.5	10.3	−1.0	−.4	14.1	.7
1970	284.9	14.0	3.8	3.8	15.6	.8
1971	304.3	31.8	19.4	17.8	16.3	1.3
1972	323.8	49.2	19.4	17.3	16.6	2.4
1973	343.0	59.4	19.3	10.3	18.5	3.2
1974	346.1	56.8	3.0	−2.6	22.4	4.1
1975	396.9	66.0	50.9	9.2	24.7	4.5
1976	480.3	69.8	82.9	3.8	28.7	4.4
TQ	498.3	74.6	18.0	4.9	7.6	1.2
1977	551.8	95.5	53.5	20.9	33.0	5.0
1978	610.9	121.0	59.1	25.5	39.2	7.9
1979	644.6	125.2	33.6	4.1	48.3	10.7
1980	715.1	126.4	70.5	1.3	60.4	11.8
1981	794.4	135.5	79.3	9.1	78.9	16.0

Source: Office of Management and Budget.

Interest payments on externally held debt impose a financial burden on future generations that cannot be dismissed as merely distributional. However, the inflow of this foreign capital has made short-run financing of the Federal debt easier and cheaper, while minimizing any possible negative effect on capital formation. In addition, it has also improved the U.S. balance of payments.

The interest burden of the debt is closely related to the maturity of privately held marketable U.S. Government debt. This debt typically consists of Treasury bills with maturities of 90 to 180 days, Treasury notes with maturities between one and five years, and Treasury bonds with maturities over five years. The average length and maturity of the debt held by private investors indicate the maturation and refinancing of securities that must be rolled over each year. For example, if the average maturity structure was ten years, 10 percent of the debt would be rolled over each year.

The shorter the maturity structure, the more refinancing costs are affected by the level of short-term interest rates. If long-term interest rates are high as well, this may make issuing long-term bonds excessively costly, thus increasing the attractiveness of short-term instruments. Otherwise, the Government would be locked into paying high rates for extended periods of time, leading to higher than necessary Federal outlays.

Since 1973, the maturity of privately held U.S. Government debt has increased. Its average length was about three years in 1973, but by 1981 it had lengthened to four years. Although the relative proportion of debt maturing within one year fell from 50 percent to 46 percent, its amount jumped from $168 billion to $558 billion. Thus, any increases in short-term interest rates exert a strong upward influence on current interest payments included in the Federal budget.

RECOMMENDATIONS

The Reagan Administration has adopted a long-run strategy for the economy that is correctly aimed at stimulating long-term economic growth. The Reagan program rejects short-run manipulations in taxes and expenditures to achieve short-run stabilization goals, but it recognizes that the long-run fiscal policy can have a powerful supply-side effect on the economy. Planned tax rate reductions and a reduction in expenditure growth have been achieved. and others have been proposed consistent with reduction in the rate of growth of Federal revenue.

In light of the current budget deficit and the need to reduce the deficit in the long run, the Joint Economic Committee Republican members offer the following recommendations.

(1) Resist pressures to reduce the current deficit by raising taxes. If there is one thing on which economic theory is consistent, it is that raising tax rates in a recession makes no sense. Whether one focuses on diminished demand or counterproductive supply effects, increased taxes are seen as debilitating to a weak economy. Moreover, proposals to increase taxes, ostensibly to lessen the deficit, will likely have a negative impact on business while collecting little revenue. A much more rational approach would be to hold the line on tax increases. A tax increase would depress economic incentives and, by prolonging the recession, increase the deficit.

(2) The Congress should support the Administration's objective of reducing the deficit by stimulating economic growth and thus tax revenues. Though large in amount, in fiscal 1982 the deficit is not unduly large relative to GNP for a recessionary period. As economic recovery follows the implementation of the President's tax program, outyear deficits will decline, though restraint in expenditure growth will be necessary to ensure this result. The reduction of outyear deficits will limit possible crowding out and thus facilitate the anticipated upsurge in capital investment. The steady decine in the size of the deficit, especially relative to GNP, will increase the pool of savings available for capital formation and sustained economic expansion.

(3) Restraint or growth in Federal expenditures must be intensified to keep outlays in line with revenue projections in the foreseeable future. Otherwise, deficits may add to the already considerable amount of the national debt and interest payments. Limiting in-

creases in the debt and its financing costs should continue to be a major priority. The only way to achieve this within the context of the tax program essential to economic recovery is by renewed efforts to trim Federal expenditure growth.

Chapter IV. MONETARY POLICY

There is considerable and widespread confusion about the thrust of monetary policy in 1981 and now. And it is understandable. Short- and long-term interest rates moved in different directions last year. The growth rates of the most commonly used monetary aggregates also provided different signals. The confusion is understandable whether the trust of monetary policy is judged by changes in interest rates or by the growth rates of the monetary aggregates.

In specific, viewed in December 1981 against the figures for December 1980, short-term interest rates declined, but long-term interest rates rose. For example, the Federal funds rate fell from 18.9 percent to 12.4 percent, and the 90-day Treasury bill rate fell from 15.7 percent to 10.9 percent. However, the yield on Treasury bonds with 10 years to maturity rose from 12.8 percent to 13.7 percent. The fall in short-term rates suggests that credit conditions eased last year. The change in long rates suggests that they tightened.

Monetary trends also were mixed. Measured between the fourth quarters of 1980 and 1981, and compared to changes between the fourth quarters of 1979 and 1980, the growth rates of the M1 measures of money fell but the growth rate of M2 was virtually unchanged. In specific, between the fourth quarters of 1979 and 1980, M1 (which was called M1B in 1981) grew 7.3 percent and M2 grew 9.6 percent. Between the fourth quarters of 1980 and 1981, the growth rate of M1 slowed sharply to 4.9 percent, but M2 growth was 9.5 percent or about the same as it was in 1980. Judged by the slowdown in M1 growth, the Federal Reserve tightened in 1981. Judged by the constancy of M2 growth, it did not.

To further confuse matters, last year, the Federal Reserve also adjusted M1 for the shift of deposits into NOW accounts from passbook savings accounts and other sources, aside from ordinary demand deposits. Federal Reserve officials viewed this variable (called M1B shift adjusted in 1981) as a truer measure of the M1 or transactions balances measure of money in 1981 than plain M1B. Shift adjusted M1B increased only 2.2 percent between the fourth quarters of 1980 and 1981 versus 6.8 percent for the period between the fourth quarters of 1979 and 1980.

It is understandable that some will look at credit developments and monetary trends for 1981 and conclude that monetary policy was relatively loose or easy while others will look at the same data and conclude that policy was relatively restrained and tight. We, therefore, begin our discussion of monetary policy by delineating precisely what we shall use to judge the direction and force of monetary policy, and why.

OUR CHOICE

We use the growth rate of the M1 measure of money—with no adjustment for the shift of savings deposits into NOW accounts—to gauge the thrust of monetary policy. The Fed's M1 data series tracks plain M1/B in 1981, M1 before that.

M1 includes coin and currency held outside the vaults of commercial banks, nonbank travelers' checks and publicly held deposits subject to check in depository institutions. It includes demand deposits in commercial banks and mutual savings banks. It also includes NOW accounts and automated transfer service accounts in banks and thrift institutions, and credit union share drafts. M1 does not include money market mutual fund shares. Some MMMF's are checkable, but none is held in depository institutions.

WHY WE DO NOT USE INTEREST RATE LEVELS AND CHANGES

Interest rate levels and changes are the most commonly used measures of the thrust of monetary policy. When interest rates are high or rising, monetary policy is said to be restrained, tight, and anti-inflationary. When they are low and falling, monetary policy is said to be easy, loose, and expansionary. This view assumes that the Federal Reserve controls interest rates. It assumes that when interest rates are high or rising monetary policy is tight, and that when interest rates are low or falling it is because the Fed has been generous in supplying reserves. Other things the same, that view is correct. However, other things are never the same, and that is the problem with using interest rate levels and changes to monitor and measure the thrust of Federal Reserve policy.

Business conditions play the dominant role in the determination of interest rates. In inflation and expansion periods, credit demands rise and competition bids interest rates up. Hence, when interest rates rise in inflation or, more broadly, expansion periods, that fact does not prove that monetary policy is restrained, tight, and anti-inflationary. Policy could be loose, easy, and acting to promote inflation. Clearly, it would be a mistake to use interest rate changes to gauge the thrust of monetary policy in inflationary or expansionary periods.

In the same way, the fact that interest rates fall in recession periods does not mean that monetary policy is easy or loose. In recessions, credit demands fall and interest rates are bid down. Falling interest rates can reflect slack credit demands. Insofar as they do, monetary policy could be promoting recession, even though interest rates are low and falling.

In summary, interest rate changes do not provide firm footing for interpreting what the Federal Reserve is doing and gauging the thrust of monetary policy.

Interest rate trends also can be misleading if they are used to find out where the economy is headed. Historically, rising interest rates were a sure sign that a recession was coming. However, inflation has made it risky in recent years to predict a recession on the ground that interest rates are rising. We were all surprised by how far interest rates climbed before the economy began to recede in 1980 and again in 1981. Inflation also has made it virtually impossible to predict from one recession to the next how far interest rates must fall in recession periods to spur spending and economic recovery. In short, because of inflation, interest rate trends have become a poor guide to what is happening in the economy and what the Federal Reserve must do to turn things around.

Our skepticism about using interest rate levels and changes to gauge the thrust of monetary policy, or the economic winds, does not mean that we are insensitive to the problems that high and rising interest rates create for householders, farmers, business firms, charitable institutions, and State and local governments. We want to emphasize that interest rates must be reduced. They must be reduced so that agriculture, housing, and small business can recover from the slumps which they have suffered in recent years, and be sustained in future years, and so that our hopes for increasing long-term capital investment can be realized. The Federal Reserve has an important part to play in reducing interest rates and keeping them down. The Fed's role is to achieve and maintain stable noninflationary monetary growth. If this is done, over time, inflation will be eliminated and uncertainty will be reduced. As a result, interest rates will fall. The premiums that borrowers and investors now pay lenders and savers for bearing the risks of inflation and uncertainty will be eliminated and reduced.

Although this may seem paradoxical, using interest rate levels and trends to monitor how the Federal Reserve is carrying out its assignment, could lead us to conclude that it was not doing it very well when, in fact, real progress was being made, or that it was doing well when it was not. The reason for this is that the initial effect of a change in money growth on interest rates is the opposite of the final effect. For example, the initial effect of reducing money growth to a noninflationary level is to increase interest rates. This is the so-called liquidity effect. In time, however, the liquidity effect is overwhelmed by the transactions and inflation effects of reduced money growth. Reduced money growth reduces the growth of transactions and ultimately also the rate of inflation. These reductions, in turn, operate to decrease interest rates. A study by the Republican staff of the Committee shows that a 1 percentage point reduction in M1 growth reduces the 90-day Treasury bill rate the same 1 percentage point in two to three years.

In summary, whether our concern is with what the Federal Reserve is doing, where the economy is headed, or whether progress is being made in reducing interest rates, we can be misled into drawing the wrong conclusions if we look at interest rate levels or interest rate changes to find the answers. The thrust of monetary policy is better measured by what is happening to money growth.

WHICH MONEY

As indicated, we use M1 growth to gauge the thrust of monetary policy. We prefer M1 to M2 growth for three reasons.

Our first reason stems from the fact that M2 includes overnight RP's, Eurodollars, savings accounts, small demonination time deposits, and money market mutual funds. These accounts are interest sensitive. As a result, M2 growth is highly susceptible to interest rate influences. M1 growth is only marginally sensitive to these influences.

Because interest rate levels and changes can be misleading, neither interest rate levels and changes nor monetary trends and changes that are readily influenced by interest rates are reliable interpretive tools. The relative insensitivity of M1 growth to interest rates is a powerful reason for using it, and not M2 growth, to measure the direction and strength of monetary policy.

Our second reason for choosing M1 growth instead of M2 growth arises from the fact that the response of the latter to changes in interest rates or, more broadly, business conditions, has been changing. This makes it difficult to use historic relationships between M2 growth and changes in economic performance variables as guides to the future.

In times past—for example, in 1966, 1969, and early in 1970—M2 growth tended to fall sharply in periods when interest rates rose and to rise sharply in periods when interest rates fell. That meant that we could expect M2 growth to slow in booms and sow the seeds of every boom period's end, and to accelerate in recession and provide a foundation for recovery. Historically, M2 growth was a good leading indicator of the economy's performance, and that was reason enough to monitor it closely. However, in recent years, M2's growth rate has begun to behave pro rather than countercyclically; rising when interest rates increase and falling when interest rates decrease. No such shift in response is encountered in using M1 data.

Our third and most important reason for using M1 growth to guage the thrust of monetary policy is that the relationship between yearly percentage changes in current dollar gross national product (GNP) and M1 growth is both close and stable. It is better in both respects than the relationship between yearly percentage changes in \$-GNP and M2 growth. If this were not the case, there would be no point in focusing on M1 for, in the final analysis, what we are interested in is the economy's performance, not the Federal Reserve's.

In this regard, we are aware of the argument that, even if focusing on M1 once made sense, it no longer does because of the development and spread in recent years of RP's, Eurodollars, money market certificates, money market mutual funds, ATS accounts, NOW accounts, electronic banking, street banking, zero and minimum balance banking, telephone transfers, credit cards, etc. Many contend both that the relationship between M1 growth and nominal GNP growth has shifted in recent years because of these new instruments and techniques, and that it has become more volatile from one year to the next. However, the facts do not bear out either one of these contentions.

We recognize that the development and spread of new banking instruments and techniques has both allowed and impelled the public to decrease its demand for M1 balances relative to nominal GNP. M1's velocity has increased. However, and this is the crucial point, M1 velocity has increased no faster in recent years than it did in the late 1950's and early 1960's.

Put otherwise, those who argue that recent developments in money markets and banking have undermined the usefulness and validity of using M1 growth to gauge the thrust of monetary policy (or as the target of policymakers) must show that M1 velocity is now rising at a faster rate than it did in the past, or at least that it is rising more unevenly. Neither of these things can be shown. Nor can it be shown that M2 velocity rises more evenly than M1 velocity from one year to the next, or that its average yearly rate of rise from one five- or ten-year period to the next is more stable.

In the last five years—from 1977 to 1981—the average yearly rate of rise of M1 velocity was 3.59 percent. For the five years preceding that, it was also 3.59 percent. For the period 1967 to 1971, it was only 1.76 percent. However, that period is not representative of the pre-1972 period. For the post-Korean War years, from 1956 to 1966, the yearly rise of M1 velocity averaged 3.57 percent. Even in the post-World War II years, from 1947 to 1955, it averaged 3.48 percent (excluding 1950 and 1951 when the year-to-year increase soared to 9.27 percent in a buying spree that lasted from mid-1950 to mid-1951 following the outbreak of war in Korea).

It is clear to us that recent banking and money market developments and innovations have not changed the trend of M1 velocity anymore than such developments and innovations as CD's, lock boxes, mail banking, Saturday banking, and the growth of the thrift industry did in the 1950's and 1960's. This is the bottom line. The average relationship over two-, three-, four-, and five-year periods between percentage changes in M1 growth and percentage changes in nominal GNP growth is essentially the same now as it was 15, 20, and 25 years ago. It is a very stable relationship. Nominal GNP has and continues to grow, on average, by 3.4 percent per year plus the average yearly percentage growth in M1. The constant term in the relationship is the average yearly rate of rise of M1 velocity.

In contrast to M1 velocity's rate of rise, that of M2, has shifted upward in the most recent five years. From 1977 to 1981, it averaged 1.25 percent per year. From 1972 to 1976, the trend of M2 velocity was negative. It declined, on average, by .4 percent a year. In the 1967 to 1971 and 1960 to 1966 periods, it also declined, by .1 and .5 percent yearly, respectively.

The data also show that the volatility of the rate of rise in M1 velocity is less now than it was in the late 1950's and early 1960's. That means that from one year to the next, the relationship between percentage changes in M1 and nominal GNP is closer in recent years than it was 15, 20 or 25 years ago. Finally, the data show that the rate of increase in M2 velocity is more changeable from one year to the next than that of M1 velocity, and that its volatility has been increasing.

Relevant statistics are set forth in Tables IV-1 and IV-2. Table IV-1 presents yearly average percentage changes in:

The dollar or nominal value of GNP,
M1,
M1 velocity in relationship to nominal GNP, and
M2 velocity also in relationship to nominal GNP for the 1956 to 1981 period.

Table IV-2 groups the M1 data in two-year and three-year periods.

TABLE IV–1.—GROSS NATIONAL PRODUCT, MONEY SUPPLY, AND VELOCITY MEASURES

[Year-to-year percent changes]

Year	Dollars minus GNP	M1	M1 velocity	M2 velocity
1956	5.42	1.17	4.20	
1957	5.29	.54	4.71	
1958	1.28	1.17	.11	
1959	8.49	2.23	6.12	
1960	3.82	.06	3.76	0.07
1961	3.57	2.06	1.48	−2.97
1962	7.74	2.46	5.15	.03
1963	5.58	3.09	2.42	−2.62
1964	6.88	3.92	2.85	−.90
1965	8.35	4.27	3.92	.23
1966	9.39	4.58	4.60	2.63
1967	5.78	3.98	1.73	−1.12
1968	9.22	7.00	2.07	.76
1969	8.08	5.93	2.03	1.76
1970	5.18	3.78	1.35	1.24
1971	8.55	6.81	1.63	−3.20
1972	10.06	7.19	2.68	−2.18
1973	11.85	7.30	4.24	1.69
1974	8.12	5.01	2.96	1.78
1975	8.03	4.69	3.19	−1.35
1976	10.89	5.71	4.90	−2.05
1977	11.64	7.64	3.72	−1.18
1978	12.41	8.22	3.87	3.22
1979	11.96	7.77	3.89	2.83
1980	8.79	6.26	2.38	−.08
1981	11.28	6.92	4.08	1.45
Using shift adjusted M1: 1981	11.28	4.62	6.36	

TABLE IV–2.—YEARLY PERCENTAGE CHANGE IN GNP, M1, AND M1 VELOCITY

[2- and 3-year nonoverlapping periods, 1956 to 1981]

	Dollars minus GNP	M1	M1 velocity
2-year period:			
1956 to 1957	5.35	0.86	4.46
1958 to 1959	4.88	1.70	3.12
1960 to 1961	3.69	1.06	2.62
1962 to 1963	6.66	2.78	3.79
1964 to 1965	7.62	4.10	3.39
1966 to 1967	7.59	4.28	3.17
1968 to 1969	8.65	6.47	2.05
1970 to 1971	6.87	5.30	1.49
1972 to 1973	10.96	7.25	3.46
1974 to 1975	8.08	4.85	3.08
1976 to 1977	11.27	6.68	4.31
1978 to 1979	12.19	8.00	3.88
1980 to 1981	10.04	6.59	3.23
3-year period:			
1956 to 1958	4.00	.96	3.01
1959 to 1961	5.29	1.45	3.79
1962 to 1964	6.73	3.16	3.47
1965 to 1967	7.84	4.28	3.42
1968 to 1970	7.49	5.57	1.82
1971 to 1973	10.15	7.10	2.35
1974 to 1976	9.01	5.14	3.68
1977 to 1979	12.00	7.88	3.83
1980 to 1981	10.04	6.59	3.23

It is clear to us that M1 growth has been and remains a reliable and useful gauge of the thrust of monetary policy and that it is a better measure of this policy than M2 growth. When M1 growth accelerates, it is a good bet that within two or three years, nominal GNP growth also will accelerate and it will do so percentage point for percentage point. Vice versa, when M1 growth is slowed, it is a good bet that nominal GNP growth will soon slow commensurately. With this well established empirical relationship in mind, we turn now to reviewing the performance of monetary policy and its impact on the economy in 1981. We present our recommendations after this review.

M1 GROWTH IN 1981

Monetary policy was in trouble when 1981 began. One reason was that inflation had doubled since late 1976. The increase in the GNP deflator was less than 5 percent between the fourth quarters of 1975 and 1976. It was nearly 10 percent between the fourth quarters of 1979 and 1980. As a result, the economy was highly susceptible to recession. Interest rates were high and rising because of inflation. The 90-day Treasury bill rate averaged 15.7 percent in December 1980. The prime rate peaked at an incredible 21.5 percent. Net worth positions had been dangerously eroded by rising mortgage and other long-term interest rates. Unsustainable imbalances between debt and income, taxes and income, and costs and profits had developed. A liquidity crisis threatened.

The Carter Administration had not been unaware of our economy's increasing vulnerability to recession because of the mounting financial problems. President Carter had moved to deal with these problems in March of 1980 by requiring the Federal Reserve to control credit flows. But that did not work. Instead, it produced a severe recession with unemployment rising from 6.2 to 7.6 percent and very little relief from inflation. There was no let up in inflation based on changes in the GNP deflator and only a little based on changes in the CPI. Credit controls were lifted in July.

To stop the 1980 recession, money growth was increased sharply. Between the second and fourth quarters of 1980, M1 grew at a 13.3 percent per year rate. That was the fastest rate of growth in M1 in any half-year period since 1945. The recession did stop. Real GNP growth was positive in the summer of 1980 and increased further in the fourth quarter. However, rapid money growth in the second half of 1980 helped create a terrible dilemma for monetary policy in 1981.

The dilemma was this. If the Federal Reserve opted to maintain M1 growth at or near the record rate of the second half of 1980, inflation would be perpetuated and ultimately accelerate, and the seeds of a calamity boom and future depression sown. However, if money growth was reduced to a rate that put us on a disinflationary track, that would make the economy extremely vulnerable to another downturn in 1981. The forces of recession had been driven back by fast money growth in the second half of 1980, but they had not been dissipated. As 1980 drew to a close, they were more dangerous than ever, evident in interest rates that were at historical highs and climbing higher, in deteriorating balance sheets and in divers other financial imbalances.

Initially, in 1981, the Federal Reserve maintained M1 money growth close to the record high rate of the second half of 1980. In the first quarter of 1981, M1 (called M1B at the time) increased at a yearly rate of 10.1 percent, measured using monthly averages of the Federal Reserve's seasonally adjusted M1 data. In April, M1 growth accelerated to 23.7 percent per year. Between April 1980 and April 1981, M1 growth was 10.8 percent. That is the highest 12-month growth in M1 recorded from World War II until now.

During the early part of 1981, the Federal Reserve may not have perceived that it was continuing to inflate the money supply at a record rate. The Fed may have been monitoring the growth of the measure of M1 which it adjusted for shifts from savings to NOW accounts. That measure's growth was negative in the first quarter. However, as in the case of plain M1, shift adjusted M1 jumped dramatically in April. It grew at an annual rate of 17.7 percent that month. Measured between April 1980 and April 1981, shift-adjusted M1 grew 8.2 percent.

Table IV-3 displays the 1981 growth records of both M1 money measures. The data show that the growth rates of plain M1 and shift adjusted M1 were very different in the first quarter but reasonably close thereafter. As a result, their velocities rose at very different rates, both in the first quarter and in the year as a whole.

TABLE IV-3.—M1 MONEY MEASURES IN 1981

[Yearly rates of changes]

Period	Plain M1	Shift adjusted M1
January	10.9	−0.3
February	5.9	−1.5
March	13.6	8.4
April	23.7	17.7
May	−5.7	−4.4
June	−7.2	−8.9
July	3.7	2.9
August	7.8	6.8
September	−2.8	−3.8
October	3.4	3.2
November	14.5	12.0
December	12.1	10.6
January 1982	[1] 27.7	
Full year 1980 to full year 1981	6.9	4.6
1st quarter (monthly average)	10.1	−.9
2d quarter (monthly average)	3.6	5.3
3d quarter (monthly average)	2.9	−.3
4th quarter (monthly average)	10.0	4.7
4th quarter 1980 to 4th quarter 1981	4.9	2.2
December 1980 to March 1981	10.1	2.2
March 1981 to June 1981	2.9	1.2
June 1981 to September 1981	2.8	1.9
September 1981 to December 1981	9.7	8.4
December 1980 to December 1981	6.3	3.4

[1] Preliminary.

In the first quarter, the velocity of plain M1 using quarterly data increased at an annual rate of 13.8 percent; that of shift adjusted

M1 at a 20.2 percent rate. Between the fourth quarters of 1980 and 1981, plain M1's velocity increased 4.2 percent versus 7.0 percent for shift adjusted M1's velocity. Measured for the whole year, M1 velocity increased 4.1 percent versus 6.4 percent in the case of shift adjusted M1's velocity.

As shown in Table IV-1, the average yearly increase in M1 velocity in the post-Korean War period is 3.4 percent. The fastest rate recorded for any whole year is 6.1 percent, which was recorded in 1959. Thus, in 1981 as a whole, as well as in the first quarter, the rate of rise of the shift adjusted M1 measure's velocity was far above the norm. In contrast, although it was high in the first quarter, the volocity of plain M1 was close to the norm for 1981 as a whole, and the first quarter rise was not outside the range of experience for quarter-to-quarter changes.

It is clear that plain M1 is a far more valid and useful measure of transactions money in 1981 than is the Federal Reserve's shift adjusted M1 measure.

M1 growth (our reference is to plain M1 from here on) was kept on an excessively slow track in the second and third quarters of 1981, and continuing through October. It did not grow at all from May to October. In no month in that period was the volume of money higher than it had been in April. As a result, the forces of recession, which had been gathering for some time, were let loose again.

With the GNP deflator having increased nearly 10 percent between the first quarters of 1980 and 1981, and then showing no signs of slowing, and with M1 growth having surged to 13 percent per year in the second half of 1980, and having been maintained near that rate through April of 1981, the Fed had to clamp down hard. It was imperative that it slow money growth and do so quickly lest inflation soar even higher and be that much harder to deal and live with.

We believe that the Federal Reserve clamped down too hard beginning last May. Looking back, it would have been better if money had grown closer to 5 or even 6 percent per year in the second and third quarters of 1981 instead of at annual rates of 3.6 and 2.9 percent. However, we should remember that the Fed should not have been in the position where it had to clamp down at all to begin with. The recession of 1981 was due to the rapid money growth the Fed engineered in the second half of 1980, and to the inflation, high interest rates, and financial problems that high money growth in the 1977 to 1980 period as a whole produced, as well to the sharp deceleraton of money growth that occurred in the spring and summer quarters of 1981. Generally, our problems have not been the result of slow money growth but of too fast money growth. In November and December 1981, M1 growth was again accelerated and this latest surge picked up speed in January 1981. The latest three-month growth rate is 15 percent.

RECOMMENDATIONS

In retrospect, our major complaint about money growth in 1981 is that it was much too erratic. No useful purpose would appear to have been served by moving M1 growth from 10 percent per annum in the first quarter to 3.6 and 2.9 percents the next two quarters, then back up to 10 percent again, as the Federal Reserve did in 1981. That kind of growth pattern is sure to make the economy perform like a rollercoaster, and it did.

In examining the rollercoaster pattern of M1 growth last year, we believe that a great mistake was made at the end of the year. The new surge in M1 growth that began in November recreates the same terrible dilemma for monetary policy in 1982 as the surge in the second half of 1980 helped to create for 1981. In this regard, we are supportive of the Fed's long announced, but so far unrealized, intention to reduce money growth to a noninflationary rate and to maintain that rate. That seems to us to be the correct horn of the dilemma to choose. Our nation cannot prosper or remain truly free if inflation persists.

We believe that some progress was made toward achieving noninflationary money growth in 1981. However, we cannot justify or excuse the extraordinary swings in M1 growth that the Federal Reserve allowed last year. These swings set money and capital markets on edge. It is difficult to plan ahead in this kind of monetary environment. No one can know at any point in time when or even if the latest swing will be reversed. As a result, investors have become speculators and long-term capital investments have been postponed. And, the increased uncertainty has provided added pressure for interest rates to remain high and even to rise further.

Last July, the Federal Reserve disclosed its preliminary target range for M1 growth for the period between the fourth quarters of 1981 and 1982. The range is 2½ to 5½ percent. Its midpoint is 4 percent, which is about 1 percentage point below actual M1 growth between the fourth quarters of 1980 and 1981. It is an appropriate target for 1982.

The long-run stability and vitality of our economy depends critically on money growth being gradually reduced to a rate "commensurate with the economy's long-run potential to increase production" and kept there, as is required by existing law. Most economists now put the U.S. economy's long-run potential to expand output at 3 percent. Realistically, we can hope for somewhat higher growth over the next few years because of the tax cuts which Congress passed last year. However, over the long run, our potential to increase production is about 3 percent per year.

M1 growth has been far above 3 percent yearly for a long time. High money growth did not give us more real growth. Rather, it was accompanied by high inflation, reduced saving and lower productivity growth.

Unfortunately, the significant surge in M1 growth that began in November 1981 and picked up speed in January 1982 raises problems for 1982.

If M1 growth now is reduced to even out the latest surge, the recovery which many economists predict will begin before midyear could be aborted before the end of the year.

We believe that M1 growth must be reduced in such a manner to make sure that the Federal Reserve stays in its target for M1 growth in 1982 (2½ to 5½ percent). By doing so, we avoid another bout with double-digit inflation, bring about a reduction in interest rates, and promote stable and vigorous real growth over the long run. If yearly M1 growth rises back to the 7 to 8 percent level of the 1977 to 1980 period, the mid-1980's are going to be marked by high inflation and high interest rates and low and erratic real growth.

What was done last year is done. Putting the lid on M1 growth completely for six months from May to October in 1981 was wrong, but now we have to look ahead. We should recognize that progress was made last year in reducing money growth and establishing the foundation for vigorous, sustainable noninflationary real growth. It would be a shame to squander that progress by a new prolonged surge of money growth, especially as we have already paid for reducing money growth. The economy has not yet adjusted to the latest surge in M1 growth. It can be evened out quickly and the 1982 target hit, and those things should be done.

Chapter V. REGULATORY POLICY

Government regulation, though desirable and beneficial in many cases, imposes heavy costs on society. Direct compliance costs have been estimated at about $100 billion by a JEC study, no small item in business costs. In addition, there are significant indirect or secondary costs--uncertainties for the investment decision process, losses in productivity, sluggish economic growth, the demise of many small businesses, and upward pressure on prices throughout the whole economy.

Excessive government regulation is a truly bipartisan concern, and well it should be. The Carter Administration made some important beginnings in dealing with this problem. The Reagan Administration has taken the process much further. And regulatory relief legislation in Congress has been sponsored both by Democrats and Republicans.

In the past two decades there has been an explosion of regulations, particularly social regulations. The *Federal Register,* where all new regulations are printed, provides the evidence. In the mid-1950's, some 10,000 pages were published in the *Federal Register* each year. By 1970, 15 years later, that number had doubled to 20,000. But by 1980, the number of pages added was 74,000. Today, the *Federal Register* is growing more slowly now that curbs have been put on the regulatory process by the Reagan Administration; the pages added in 1981 were 58,000.

Many government regulations, particularly those affecting health, safety, and the environment, have contributed significantly to the well-being of the vast majority of American consumers and workers. We would not turn back the clock because many regulatory policies have produced substantial benefits for the public.

However, heretofore the benefit goals of regulations have been set with very little regard for the costs they impose. Much of the fault for this lies with Congress, as some laws have allowed regulations without requiring that costs or benefits be weighed, while other laws actually have prohibited the consideration of costs. The time has long since passed for consideration of the cost side of the regulatory coin.

The problems differ with regard to economic regulation and social regulation. Until the mid-1960's government regulation was aimed primarily at achieving strictly *economic* objectives, such as control over monopoly or stabilization of an industry, and did so through intervention in the marketplace in the form of controls over prices, entry requirements, or other aspects of economic activity. In specific industries, primarily transportation, banking and communications, the effect of economic regulation has generally been to raise the level of consumer prices or rates above the level that would have prevailed in the absence of regulation.

A more recent source of regulatory burden is the rapid growth of Federal *social* regulation. During the past 20 years, Congress has enacted numerous measures dealing with clean air and clean water, more healthful workplaces, fair credit practices, toxic substance control, highway and auto safety, strip mine controls, interstate land sales, and consumer product safety, as well as other important social concerns. In contrast with economic regulations which affect few industries, social regulations seek specific objectives across a broad range of industries. It should be noted that many of these social regulations have been directed at having private industry internalize the costs previously borne by society as a whole. It is this avalanche of social regulation that makes up the bulk of the $100 billion in annual compliance costs referred to earlier.

A problem with social regulation, quite apart from the cost problem, is the lack of coordination among regulatory agencies that has often resulted in regulations which are duplicative, conflicting, and excessive. Witnesses appearing before the Joint Economic Committee have provided examples of instances where compliance with one regulation requires violation of another. This not only puts businesses in unnecessary jeopardy, both legally and financially, it also reduces respect for the law and the Federal Government. Small businessmen are often hardest hit by the morass of conflicting and duplicative regulations because they cannot afford the necessary legal advice.

We are pleased that President Reagan has recognized the stagnating and inflationary impact of government regulations and has taken measures to improve the regulatory process. The creation last year of the President's Task Force on Regulatory Relief under Vice President Bush has resulted in the elimination of many needless and unproductive regulations and has resulted in the current and future saving of billions of dollars of compliance costs. These results apparently have come without jeopardizing the ability of regulatory agencies to carry out essential congressional mandates.

ECONOMIC REGULATION

Federal economic regulation began with the establishment of the Interstate Commerce Commission (ICC) in 1887, and by the 1930's most of it was in place. The Federal Trade Commission (FTC) was established in 1914. In the 1930's we had the Federal Power Commission (FPC), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Federal Communications Commission (FCC), and the Civil Aeronautics Board (CAB). More recently we have seen the establishment of the Federal Energy Administration (FEA) in 1973 and the Commodity Futures Trading Commission (CFTC) in 1975.

The initiation of much of the industry-specific economic regulation in the 1930's came at at time when the public generally thought that government should and could solve many perceived social and economic problems. Economists and the general public now realize that Federal regulatory activities can exert a negative impact on the economy; it can raise prices and lower capacity, product quality, and service. It reduces the economy's ability to adjust efficiently and swiftly to technological change. In turn, this reduces productivity growth.

Productivity in major regulated industries—electric, natural gas, telephone, airline, and railroad—was quite adequate in the 1960's and earlier. But in the 1970's productivity in some of the regulated industries—particularly natural gas, railroads, and electric industries—began to trail even the sluggish U.S. total productivity of that era.

Between the early 1960's and early 1970's output per manhour fell 9 percentage points in natural gas, 8 percentage points in airlines and railroads, 4 percentage points in electric power. Only in telephone service did productivity growth increase between these two periods. In the early 1970's productivity in natural gas and railroads was negative.

The tendency of regulation to produce rigidity is one of the major causes of diminished productivity. Firms with discretion to base prices on costs have greater incentive to discover and meet demand for new services. Allowing firms to reflect the costs of new technologies in rates and to engage in promotional pricing of new services would increase variety and accelerate the pace of change. Such variety would also result from relaxation of entry restrictions. Firms with access to new technologies or with new product or service ideas would be more readily able to enter the market. For example, the Interstate Commerce Commission has, in the past, severely restricted common carrier trucking firms trying to choose the most efficient routes for their trucks. And regulations that rigidly segmented both the telecommunications and financial industries helped thwart innovations that would have improved productivity. Moreover, once regulations are issued, they are seldom given a fresh look to see if they should be altered in the light of new knowledge or new conditions.

In several industries—airlines, railroads, trucking, energy, telecommunications, banking—significant reform has already been achieved. The Civil Aeronautics Board, the Interstate Commerce Commission, and the Federal Communications Commission, have acted administratively to reduce the burden of regulation where their statutes allowed them to do so, and new legislation, begun in 1975, has carried the process even further.

The Airline Deregulation Act of 1978 was the first major industry deregulation achievement. Since then, Congress also has taken major deregulation steps in common carrier trucking, interstate movers of household goods, railroads, and financial institutions. Meanwhile, the decontrol of domestic crude oil prices and phased-in natural gas decontrol provide a spur to the exploration and development of new domestic sources of oil and natural gas and aid energy conservation.

Deregulation has not often gone smoothly. But the overall results to date have been good. For example, there have been some strange gyrations in airline fares, but productivity improvement permitted by deregulation prevented the sharp rise in energy prices of the 1970's from resulting in even larger increases in unit costs and thus in still higher air fares; and air rates are comming down currently.

For railroads, energy shortages and rising energy prices caused different problems. Federal legislation enacted in 1976 provided the railroads with increased rate flexibility, but this initial "deregulation" ran into some snags. The booming demand for coal prompted the railroads to raise coal-hauling rates sharply. The fear of even more rapid increases if the ICC controls were lifted, caused opponents of further deregulation to press for continuing ICC surveillance of coal-hauling and other bulk commodity rates. A compromise was reached that permitted a relaxation of the ICC's rate-approval authority on a pre-arranged schedule. In this way, the railroads were given some freedom to alter rates to meet shifting market conditions; at the same time, rail users were provided some protection against abuse of this freedom.

Financial Institutions

The banking industry is the most extensively regulated of all industries. The Depository Institutions Deregulation and Monetary Control Act of 1980 made a beginning in turning this around, yet much of the intricate mass of bank regulation built up over the last half century was left untouched by the 1980 Act. Basically what the 1980 Act did was dismantle the anticompetitive cartel structure that was created by the Banking Act of 1933. Placing on the statute books developments that had been taking place in the 1970's anyway, banks no longer have a monopoly on checking accounts, and, by authorizing various substitutes for checks (NOW accounts, etc.), the prohibition of interest on demand deposits is finally eliminated.

The 1980 Act made some major strides toward a more viable financial system. Interest rate ceilings on time and savings deposits were to be phased out over six years and S&L's were given expanded asset powers, allowing them to place up to 20 percent of their assets in consumer loans. The Act repealed State usury interest ceilings on consumer and business loans. These ceilings had seriously depressed such lending in certain States.

In the mid-1960's, there were many restrictions on depository institutions. The motivation behind these restrictions was to maintain a sound financial system while providing housing markets with a sufficient flow of funds. For the financial system this meant specialization. Commercial banks provided "full service" banking to households, businesses, and governments, while thrift institutions had a more limited role as the principal repository for household savings and the major source of funds for residential mortgages.

This compartmentalized financial system worked pretty well from the 1940's through the mid-1960's. Financial markets were relatively tranquil. But, beginning in the mid-1960's, sharp swings in interest rates and higher and higher peaks propelled by inflation, induced sweeping changes in financial markets. Ceilings on deposit interest rates lagged behind rising market interest rates and disintermediation became a painful thorn to thrift institutions and banks and also became a new term in our vocabulary.

Despite efforts to hold their competitive position by finding new ways to attract funds outside the purview of Federal regulation, banks and thrift institutions still were unable to provide a fully competitive range of financial services. Nondepository institutions, much less burdened by regulation, found the banking markets profitable and they began issuing deposit-like instruments and offering bank-like services. The most impressive competition came from the money-market mutual funds. These provided small savers high, competitive yields while offering substantial liquidity, including limited checking services. Money-market mutual funds did not even exist in 1970, but today they have a value of $188 billion.

The piecemeal modernization of the financial system in the 1970's, culminating in the Depository Institutions Deregulation and Monetary Control Act of 1980, has helped depository institutions to compete but regulations affecting these institutions still need more sweeping reforms.

Adverse interest rate action in 1980 and 1981 threatened the solvency of hundreds of thrift institutions and some banks. The problem is simple and serious: On average in 1981, savings and loans earned 9.7 percent on their portfolios, but they paid out 10.9 percent to obtain funds. Losses in the industry amounted to about $5 billion in 1981. Obviously this cannot go on or S&L's will be out of business in the not too distant future. Fortunately, cost of funds rates peaked in October 1981 and are coming down now. If the trends continue, the S&L's should be off the ropes by the second quarter of 1982.

Changes in the financial regulatory structure in the 1970's and early 1980's have helped to make regulation compatible with much of the new financial environment. But, the challenge for the 1980's will be to go further to achieve the appropriate balance between unnecessary restraints on the market and the regulatory goals of preserving the safety and soundness of the financial system.

Concluding Comments on Economic Regulation

With all of its problems, and recognizing the political difficulties of doing so, aggressive deregulation of major industries is an important objective of public policy if we hope to increase productivity and promote more rapid economic growth. It is essential to dismantle the regulatory barriers to efficient pricing and to do so relatively quickly. If necessary, separate action can be taken to provide compensation for losses or to prevent unusual windfall gains, but deregulation should go forth.

We recommend that the legislation enacted in 1980 on trucking deregulation be fully implemented as soon as possible. Renewed efforts to further deregulate the railroad industry should be undertaken. In the financial industry a stepped up schedule for removal of deposit interest ceilings, coupled with expanded powers for thrift institutions and legislation to facilitate bank and thrift institution mergers across State lines, are in order.

SOCIAL REGULATION

While a large part of the economic regulation placed on the statute books over the years has been eliminated or substantially reduced, Federal regulations designed to protect the environment and the health and safety of both workers and consumers goes on, and, in most cases, this is appropriate policy. Much public good flows from these social regulations.

However, Federal social regulation is flawed in many ways. Much of it was put on the books with tunnel vision—concern only for the end result, with virtually no concern whatever for the costs imposed on society. If these costs were minor, there would be no problem. But they are huge, and they are growing.

Regulatory reform was a third and important plank in the Reagan Administration's Economic Recovery Program. There has been a major change in attitude and philosophy of regulation. The pro-regulation wave has been broken and is beginning to recede. Early actions by President Reagan to chip away at the entrenched regulatory framework were swift and forthright. For example:

January 21: A Presidential Task Force on Regulatory Relief is created.

January 29: A freeze is placed on all regulations proposed by the outgoing Administration that were not yet effective.

February 17: The President issues Executive Order 12291 setting forth regulatory principles and calling for review by the OMB of all *new* regulations and reassessment and posssible modification of selected *existing* regulations.

The accomplishments in 1981 under Executive Order 12291 were quite impressive. The Office of Management and Budget received 2,781 new regulations for review and completed review of 2,715. Of these, 2,412 were found consistent with the Executive Order without change, 134 were found consistent with minor changes and 91 were returned to, or withdrawn by, the agencies. The remainder were exempt from the Order.

A total of 91 existing regulations and 9 paperwork requirements were designated for review. Actions were completed on 38 of the existing regulations, with 27 more to follow by the end of March 1982. Substantial reductions in paperwork burdens will soon be announced for three of the designated paperwork requirements.

In addition, the number of Federal Register pages has fallen by one-third during the first ten months of 1981 compared to the same period of 1980. The number of rules published in the Federal Register has decreased by about 25 percent for the same period. Roughly half as many major regulations were published during the first ten months of 1981 as during the same period of 1980.

Altogether savings of $2.8 to $4.8 billion in capital investment costs and $1.8 to $2.0 billion in annually recurring costs have been achieved.

However, there needs to be fundamental changes in some statutes and in regulatory agency performance before the goal of sound regulation reform can be fully achieved.

Two basic concepts are at issue: (1) the micro concern for the cost and efficiency of specific regulations and (2) the macro concern for the overall total compliance costs which regulations impose on society. The first concern can be met by a "least-cost alternative" requirement and the second concern by a "regulatory budget."

Regulatory programs should attempt to consider costs and benefits whenever possible. A cost-benefit test for government regulations, as desirable as it might be in theory, however, poses many problems in practice.

First, it is often impossible to measure the benefits of regulatory programs. What is the value of a human life? Second, the imprecise nature of the data needed for accurate benefit-cost analyses of regulations would make it easy for such studies to be manipulated to achieve a predetermined result. Third, there is the distinct possibility that regulatory decisions made solely on the basis of cost-benefit analyses would be morally repugnant. For example, if lives are valued on the basis of earnings potential, as they are in many cost-benefit analyses studies, highway safety programs would be concentrated in wealthy neighborhoods, since the economic value of a life saved there would exceed the economic value of a life saved in poorer neighborhoods.

Fortunately, for most regulatory programs, such computations are not necessary to reduce regulatory-imposed waste and inefficiency. Congress, in enacting regulatory programs, generally presumes or sets a level of benefits to be achieved, just as it does with spending programs. The benefit level is not, and should not be, determined by the administering agency. Rather, the agency should be charged with achieving the congressionally mandated goals at the least cost. This eliminates the need to measure benefits precisely and instead focuses on costs which can be more accurately measured.

A cost-effectiveness requirement is the simplest way of assuring that regulatory goals are achieved at the lowest possible cost and with the least waste of resources.

The Administration has adopted such an approach in Executive Order 12291, issued February 17, 1981. Under that Order there is the general requirement that regulatory actions will not be undertaken unless the potential benefits to society outweigh the potential costs, and that regulatory priorities should be set on the basis of net benefits to society. But, the benefit measurement problems just cited mean that this cost-benefit assessment will be very general.

Of most relevance, Executive Order 12291 directs agencies to determine the most cost-effective approach for meeting any given regulatory objective and requires that factors such as the economic condition in an industry and in the national economy be taken into account.

The Order requires a description of alternative approaches that could substantially achieve the same regulatory goal at lower cost, together with an analysis of the potential benefits and costs and a brief explanation of the legal reasons why such a less-cost alternative could not be adopted, if it is not adopted.

The major flaw in the Administration's Executive Order, however, is that it does not cover the 19 Independent Agencies, and the Constitutional history on this question is ambiguous. This is unfortunate because some of these agencies are very active in the social regulation process. They include the Consumer Products Safety Commission, the Nuclear Regulatory Commission, the FTC, the financial institution regulators (Fed, FDIC, FHLBB, SEC) and others.

A few of the agencies have volunteered to comply with the overall spirit of the Executive Order and some of its requirements. But in fact the Administration has only limited powers with respect to independent agencies. To fully reach them and to avoid Constitutional battles in the process, the President needs the cooperation of Congress.

A second major concern is with the overall total cost of compliance with regulations and the impact on the economy, the macro problem.

The current regulatory process fails to recognize that the goals of regulatory programs must be balanced rationally with other national objectives. The achievement of any objective, public or private, involves resources that could be used for several purposes. The more resources that are devoted to one purpose, the less available for others. Even if all regulations were cost effective, the problem of balancing resources for regulatory purposes with resources for other purposes would still exist. This balance could best be accomplished by a regulatory budget.

Prior to the rapid growth of social regulatory programs, the present fiscal budget was generally adequate to show the impact of government on the economy. Almost all the activities of the Federal Government involved direct spending, in the form of purchases or transfers, or direct taxation, and these showed up in the budget. There were very few regulatory programs.

One could have a fairly clear picture of the Government's influence in the economy by reading the budget. But with the rapid growth of the new regulatory agencies—the Occupational Health and Safety Administration, the Environmental Protection Agency, the Highway and Traffic Safety Administration, and the many others—the Federal budget no longer conveys a complete picture of the Government's economic impact.

The annual fiscal budget understates the proportion of the Nation's resources that are used for public purposes. Spending in the private sector for auto safety, mine safety, pollution control, and consumer protection, plus the attendant government-required paperwork, do not appear in the budget. Nor do the possible higher prices paid by consumers because of economic regulation. The costs and benefits of both social and economic regulations should be more clearly available to policymakers.

Consideration should be given to developing an annual regulatory budget to set a limit on the costs of compliance each agency could impose on the private sector.

What we are dealing with here is a third aspect of our budget process. The present budget is essentially an administrative budget containing the "on-budget" items. There are also 13 "off-budget" agencies not now included in the budget, such as the Federal Financing Bank, with total direct expenditures of about $21 billion in fiscal 1981. There are proposals for folding these off-budget expenditures into the regular budget.

"Off-off-budget" spending, the costs of compliance with Federal regulations, should *also* be shown in the budget. These costs have a financial impact on businesses just as a tax would, and an impact on the economy just as Federal spending would. For example, the massive cost of a smokestack scrubber to achieve cleaner air is passed on directly to the consumers, who pay higher utility bills as surely as they pay taxes.

While a regulatory budget would provide an incentive for the regulatory agencies to limit the compliance costs of their regulations, it would have other important purposes as well. A regulatory budget, along with the fiscal budget, would provide a more accurate picture of the Federal Government's total impact on the economy. It would provide an effective tool for determining what percentage of the Nation's output should be devoted to public uses and what percentage should be devoted to private uses. It would make possible a better balance between regulatory programs and traditional spending programs.

Although some regulatory costs will be hard to measure, many costs *are* measurable, including the costs of required investment, paperwork, and changes in product quality. All costs need not be measured, as long as there is consistency in *what* costs are measured in applying the requirements of the regulatory budget across the board to all regulatory agencies.

With intelligence and skill, the problems can be overcome, just as they were in developing the fiscal budget. With the rapid increase in the costs of compliance with social regulation, a regulatory budget is essential. Congress should begin the process to make it a reality.

Chapter VI. INTERNATIONAL ECONOMIC POLICY

Over the last decade, the interdependence of the international economic system has risen dramatically, greatly increasing U.S. vulnerability to events overseas and other nations' sensitivity to U.S. economic policy and policymaking. The international community's conversion to flexible exchange rates in 1973 increased the fluidity of the capital system and enabled countries to pass through more easily to overseas partners the effects of foreign exchange-related and domestic economic decisions. The tenfold rise in oil prices fueled inflation, placed severe strains on financial resources and increased the worldwide need for conservation and the development of alternative energy sources.

Trade and investment have also become more important elements of our economy. In 1970, U.S. exports constituted 4.5 percent of our gross national product. Today, they account for nearly 8.5 percent, while imports have a 12 percent share. Moreover, in 1980, U.S. investment abroad exceeded $200 billion, and foreign direct investment in the United States was $66 billion.

Increasingly, the United States finds itself forced to operate in a predominantly international, rather than national, setting. The previous Administration, however, failed to take into account the extent to which economic policy decisions, made primarily for domestic reasons, affect our trading partners. As a result, U.S. action exacerbated international economic instability and led to foreign demands that we "get our economic house in order."

The previous Administration's domestic inflation rates of over 13 percent eroded confidence in the dollar worldwide, further destabilizing markets. Moreover, its massive intervention purchases of foreign currencies to stabilize the dollar had little descernible beneficial impact. These purchases treated only the symptoms of our national economic decline and not its underlying causes.

In trade, governmental policies and private sector pressures at home had important effects for the U.S. foreign suppliers. Ever-increasing balance of merchandise trade deficits resulting from declining U.S. productivity and competitiveness led to renewed calls for import protection in such sectors as steel, automobiles, and textiles.

Actions taken overseas likewise affected the U.S. economic picture. Foreign restrictions on the nature and scope of U.S. direct investment, for example, distorted capital markets and led to less-than-optimal placement of capital. Uncontested agricultural export subsidies from the European Community to member state farmers seriously injured U.S. producers seeking to sell overseas. In addition, aggressive export practices by the Japanese escalated pressure on the U.S. market, expecially for steel, autos, and electronics products. Domestic capacity utilization declined, and the number of jobs available in the automotive and auto-related sectors in particular was reduced by one million.

LONG-RANGE POLICY RECOMMENDATIONS

(1) The same policies that promote our domestic economic recovery will restore our global trade competitiveness and stability in international financial markets. In the monetary area, a policy providing for gradual but consistent increases in the money supply is necessary for growth at home and abroad.

U.S. firms must have predictability in capital markets before they are willing to make the kinds of investments needed for productive plant and equipment. Such investment would lead to per-unit cost savings and improved products and hence greater international competitiveness. Monetary stability at home would also go a long way toward reducing inflationary expectations, thus improving the price attractiveness of U.S. goods and services.

(2) In the foreign exchange arena, the emphasis should be on allowing the marketplace to work.

Repeated interventions in the foreign exchange market serve primarily to undermine confidence in the dollar and may elicit equally distortive exchange-rate related reactions from our foreign partners. As in domestic monetary policy repeated interference in exchange rates encourages nonproductive speculation and misuse of scarce capital. The United States should, therefore, continue the Reagan Administration policy of intervening in foreign exchange markets only when necessary to counter disorderly conditions.

(3) U.S. international investment policy should concentrate on reducing distortions and restrictions overseas while maintaining openness at home. Once again, the emphasis should be on allowing the marketplace to function relatively freely.

International investment yields benefits to the United States as well as to the rest of the world. At home, profit on our overseas investments contributes to a positive balance of payments. And its contribution has been growing. In 1960, U.S. earnings on foreign direct investments were only $3.6 billion. By 1970, those earnings' contribution to the current account reached $8.2 billion, and since then, the inflows have roughly quintupled to an estimated $41 billion for 1981. These repatriated profits have added to our scarce domestic capital supply and expanded employment opportunities in the United States.

U.S. investment overseas is also advantageous for foreign partners, increasing their store of capital and freeing up domestic financial resources. In addition, international investment has eased the recycling of petrodollars. Nevertheless, numerous countries impose strict limitations on foreign direct investment, holding of foreign securities, bank deposits and loans, and the ownership of real estate. Such restrictions greatly distort the investment decisionmaking process and conflict with the principle of free flow of goods, services, and capital to which the United States adheres.

Further distortions are so-called investment-related "performance requirements" imposed by developed and developing countries alike. From Mexico with its Decree for the Development of the Automotive Industry, to India with its rules for investment in sophisticated technology, to Canada with its Foreign Investment Review Agency, there is an increasing tendency for countries to require that, as a price for equity participation, the foreign investor will use a specified percentage of locally produced components and will export all or part of his output. Many of these requirements are imposed long after the investment has taken place, when firms, saddled with sunk costs, have no choice but to comply or risk losing valuable assets.

No matter what form, however, performance requirements are highly distortive. They increase pressure on the world's more open markets—including the United States—to absorb output, and they impose artificial constraints on investment decisions.

On the domestic front, the United States should continue to maintain an open market policy for investment. Foreign capital inflows increase the supply of private money vitally needed for investment in modern and more productive plant and equipment. Such investment, in turn, contributes to a restoration of high productivity growth rates and a concomitant rise in U.S. international competitiveness.

(4) The United States should continue the present trend toward emphasizing bilateral over multilateral aid and private over public participation in economic development.

There is no doubt that multilateral institutions, such as the World Bank, play a key role in today's international economy. Throughout the 1970's, the commercial banks took surplus funds of the OPEC cartel and recycled them to nonoil developing countries. However, the existing debt burdens, a worldwide downturn in demand, and growing concern over other countries, future ability to service debt through earnings—rather than through additional loans or rescheduling—have dissuaded some commercial banks from further lending. International financial institutions have been called on increasingly to take up the slack.

The United States had traditionally played an important rule in these multilateral development institutions. The U.S. share of the most recent capital increase or replenishment of development banks, for example, ranges from 16 percent in the African Development Bank to over 34 percent in the Inter-American Development Bank. Total budget authority for the banks rose from $1 billion for FY 1981 to over $1.26 billion for FY 1982, an increase of 26 percent. Moreover, the United States has been a major force in the International Monetary Fund, lending it support for the stability of economies overseas.

While such multilateral participation is important, the United States must recognize the benefits to accrue at home and in the developing countries from an increased emphasis on bilateral strategies. For the United States, bilateral assistance has important export advantages, both in the initial stages of economic development projects and in terms of building the basis for long-term developing country demand for U.S. goods and services. For developing countries, bilateral approaches allow greater freedom to the private sector and should enable governments, over time, to reduce official debt burdens, increase aggregate private investment, expand technical training, and achieve realistic exchange rates.

(5) As an over-arching policy, the United States should stress increased trade over aid.

Export earnings are a more significant source of development finance than aid, both in terms of the amount of money involved and by virtue of the economic efficiency that a successful export industry represents. Of total U.S. imports in 1980 of $241 billion, $62 billion, or 26 percent, were from developing countries. By contrast, total U.S. economic assistance to developing nations in 1980 was $7.3 billion. Export-led economic growth has enabled countries in the Far East and Latin America, in particular, to advance rapidly and provide a sound basis for continued expansion.

To encourage the development of trading ability, the United States should continue to provide special benefits to imports from developing countries under the U.S. Generalized System of Preferences (GSP). The U.S. GSP program grants duty-free treatment, up to a certain import percentage or dollar value limitation, on approximately 2,800 items from 140 beneficiary developing countries and nonindependent territories. In 1979, $6.3 billion in goods entered the United States duty-free under this program. In 1980, these imports reached $7.3 billion, and final 1981 figures are expected to reach $9 billion. The U.S. GSP is illustrative of our commitment to achieve market-based growth in developing countries thereby reducing, over the longer term, those countries' requirements for financial assistance.

At the same time as we encourage economic development through trade, however, the United States should more thoroughly implement the concept of "graduation," i.e., phasing the more advanced developing countries out of preferential treatment in internationally competitive sectors, thereby distributing GSP advantages among a wider scope of beneficiary countries.

In 1978, five countries—Brazil, Mexico, Taiwan, Korea, and Hong Kong—accounted for 70 percent of the goods imported into the United States under the U.S. GSP. In 1980, their share had declined to 60 percent and in 1981 is expected to be smaller yet. Nevertheless, these countries' share remains excessively high, and the United States should take steps to ensure they begin to compete on an equal basis with more developed countries and accept the greater obligations and responsibilities that accompany increased international competitiveness and strength.

(6) The United States should emphasize the benefits to accrue from free and fair trade and should achieve expanded export opportunities for U.S. suppliers.

Free trade is essential to a strong U.S. economy. Moreover, exports generate larger real income and more jobs, while imports increase consumer choice and strengthen competition. Through expanded trade, we enjoy lower prices, reduced inflationary pressures, and more efficient use of the Nation's resources.

Increased exports are an essential part of efforts to revive the American economy and to strengthen American influence abroad. Currently, over 3.5 million Americans are employed in the export sector, and it has been estimated that a $1 billion increase in U.S. industrial shipments overseas could increase this employment level by another 40,000.

If exports are to be a principal engine of growth in our economy, however, we must couple should domestic economic measures with fair treatment from our trading partners.

One of the major accomplishments of the 1975-to-1979 Tokyo Round of Multilateral Trade Negotiations was the development of codes of conduct on nontariff barriers. These distortions, which have been taking on increasing importance as worldwide tariff levels have declined, primarily take the form of export subsidies, unfair pricing and discriminatory government purchasing practices. The multilateral codes were designed to establish discipline in, or eliminate the use of, these measures.

Notwithstanding the existence of these agreements, however, foreign trading partners continue to restrict imports, reducing U.S. global sales opportunities. Japan, for example, continues to severely restrict the importation of agricultural products, including beef and citrus. The European Community—as part of its Common Agricultural Policy—provides an unfair competitive edge to its exports of farm goods through the use of government subsidies. U.S. producers of sugar, wheat, wheat flour, and poultry have all complained of sales lost to European competitors as a result of the latters' unfair advantage. U.S. speciality and carbon steel manufacturers have filed cases citing "dumping" and subsidization of exported steel from Europe, Latin America, and South Africa. Thus, the anti-free trade policies continue.

The United States must impress upon its partners by word and deed that trade must be conducted according to mutually agreed "rules of the game" and open market policies. While a stable dollar, improved products, and greater marketing skills for U.S. producers will surely go a long way toward improving the saleability of American goods and services, we will achieve only limited results overseas unless our trading partners allow the marketplace to operate freely, unfettered by insidious nontariff distortions to trade.

The other side of the coin is the elimination of unnecessary barriers to exporting that result from U.S. laws and regulations. The United States took an important step toward achieving this objective through the Economic Recovery Tax Act (ERTA). Under the previous system of taxation, U.S. businessmen and their families who represented our exporting interests abroad were penalized with excessive assessments on the higher costs of living overseas. ERTA reduced this tax bite with an exemption for the first $75,000 in income earned abroad, plus a deduction for housing and other expenses.

More remains to be done, however, to reduce export disincentives. Congress must still approve legislation allowing for the establishment of export trading companies that can benefit from bank equity participation and immunity from certain antitrust restrictions. Moreover, action must be taken to clarify the application of the 1977 Foreign Corrupt Practices Act (FCPA). Because of the ambiguous terms of this law and the fear of liability for the actions of overseas sales agents, small- and medium-sized firms in particular have been discouraged from breaking new export ground. Moreover, the costs of complying with the accounting and recordkeeping standards of the law are prohibitive. While the United States must zealously guard against bribery, it can do so without the overly restrictive and vague terms of the present FCPA.

It is estimated that only 2 percent of U.S. firms account for 80 percent of our exports. There are between 20,000 and 30,000 smaller and medium-sized firms that could be selling overseas but do not do so because of lack of adequate financing and marketing know-how. Moreover, they are stymied by the myriad of laws and regulations, often imposed for legitimate domestic purposes, that confuse and discourage international risk taking. The removal of these disincentives must be a high priority if exports are to play a dominant role in our economic recovery.

(7) At the same time as we pursue policies that promote exporting, the United States should increase job opportunities for those adversely affected by foreign competition.

Through tax policies to encourage research and development, the U.S. Government can foster investment in productive sectors and greater employment opportunities in competitive industries. Moreover, by allowing for the smooth operation of the marketplace, the United States will provide stability for firms, facilitate long-term planning and investment, and ensure job security for U.S. workers in all sectors of the economy. To promote this goal of economic growth, attention should be paid to increasing cooperation between business, labor and government, and improved training programs for workers.

(8) Agricultural exports deserve special attention, since, along with services, they have shown growing strength in the international arena. The United States should pursue domestic monetary and fiscal policies and international trade strategies that will encourage the maintenance of a strong agricultural export sector, as well as an increase in the share of processed agricultural commodities in our export totals.

The agricultural sector is of vital importance to the U.S. economy. Farm products directly and indirectly account for approximately 20 percent of our GNP and about 23 million jobs. Agricultural exports account for 20 percent of all American exports and should bring in an additional $45 billion in 1981, for a balance of farm trade surplus of $28 billion. One of every three acres of harvested U.S. cropland now produces for the export market, and these agricultural exports not only improve our balance of payments but also boost the domestic economy. For every additional $1 billion in overseas farm sales, approximately 35,000 domestic jobs are created.

U.S. farmers are the most efficient producers in the world for most temperate agricultural products. Moreover, our producers have become increasingly successful at selling their output overseas. In 1960, the value of agricultural exports represented only 15 percent of farmers' cash receipts. In 1980, exports' share had risen to one-quarter.

This strong performance is threatened, however, by unfair import barriers and other countries' agricultural export subsidies. U.S. farmers find themselves increasingly obliged to compete with overseas producers protected from worldwide market forces. They cannot be expected to do so forever.

Moreover, exporters of processed agricultural goods face high and growing barriers to importing into countries like Japan.

Our agricultural export success will quickly disappear unless the United States settles trade problems with overseas competitors and places all international transactions on a free market basis.

Chapter VII. AGRICULTURE

The economic activity generated by farm products as they flow through our economic system accounts for a full 20 percent of this Nation's gross national product and makes agriculture this Nation's largest industry and employer. For example, a one million dollar export sale of wheat generates almost $5.5 million of direct, indirect and induced business activity. Agriculture's assets today are nearly $1 trillion, almost $^{9}/_{10}$ths as large as the combined assets of all manufacturing corporations in this country. The 23-million plus people who are employed in agriculture and related businesses—the growing, storing, transporting, processing, merchandising and marketing of all farm commodities—make up a fifth of the Nation's labor force. The product of one out of every three acres harvested is exported, resulting in farm exports exceeding imports by $28 billion; the largest positive net contributor to our balance of payments.

U.S. families spend only 16.5 percent of their incomes for food, by far the lowest percentage of any country in the world, freeing billions of dollars of income for the purchase of other goods, savings and investment. Agriculture is also a big consumer, using enough steel to account for 40,000 jobs in the steel industry and enough electricity to power all the homes in New England, Maryland, Kentucky, and Washington, D.C. Farmers annually purchase $14 billion of farm machinery and $13 billion of fuel.

The primary risk-takers in agriculture are the owners of America's approximately 2.4 million farms. Perhaps the most striking characteristic of present day farming is that, in the aggregate, nonfarm income earned by farm families exceeds what they earn from farming. In fact, only 1 in 12 farm families depend entirely on farming for income. Nonfarm sources of income have helped the agricultural sector to adjust to volatile demand and supply situations and wide swings in farm prices and incomes. But, at the same time farming is now, more than ever, influenced by those economic conditions which impact the typical city wage-earner such as social security taxes, unemployment insurance and, of course, unemployment itself.

Agriculture is an inherently unstable business. Natural forces—weather, pests, diseases—coupled with market uncertainty and instability arising from changing economic and political events throughout the world, more often than not, dictate the farmer's fate. This was certainly the case in 1981 when unusually favorable growing conditions, resulting in record production levels for virtually every major product, were coupled with generally unfavorable economic conditions in the U.S. and in major U.S. trading countries. Net farm income before inventory adjustment is expected to be about $19 billion for 1981, a 13-percent decline from 1980.

Farm income levels for 1982 will depend on the timing and strength of economic recovery in the U.S., political, economic and trade policies of major U.S. trade partners and, of course, the weather, both in the U.S. and in other countries. Agriculture has already had two consecutive years in which net farm income in constant dollar terms has been lower than at any time in more than 40 years. While strong U.S. economic recovery in 1982 will be a significant contributor to reversing this disastrous trend, there is no guarantee that agriculture will fully share in the benefit; farmers were not helped much by the last "recovery" in 1980–81. Actions must be taken to ensure that agriculture is a full participant in the next recovery.

The Reagan Administration has taken important steps to aid the agriculture economy. The net income position of U.S. farmers will be improved in 1982 as a direct result of several provisions of the Economic Recovery Act of 1981. That Act affects farmers in three highly important areas: (1) a 23-percent reduction during the next two years in marginal income tax rates, with tax brackets indexed for inflation starting in 1985; (2) a reduction in the maximum capital gains tax rate from 28 percent to 20 percent; and (3) a limit on the imputed interest on land sales between family members to 7 percent for tax purposes. These excellent provisions are in addition to those contained in the recently enacted four-year farm bill, which is expected to provide U.S. farmers with an estimated $11 billion of benefits. However, these actions will still fall short of assuring farmers an adequate income. This important sector of our economy requires continued surveillance and possibly further action to assure its viability.

ADDITIONAL VIEWS OF SENATOR WILLIAM V. ROTH, JR.

While I agree with the general thrust of the Republican views and their emphasis on long-term growth as the best means of permanently reducing inflation, interest rates, unemployment, and Federal budget deficits, I believe more emphasis must be placed on the needs of the American people during these trying times. In particular, we must recognize that high interest rates have discouraged investment in productivity improvements and employment opportunities, and that further budget cuts—while critically needed to reduce deficits—can be made only if the needs of those most adversely affected are met. I believe that, throughout the process of meeting our economic targets and getting our economy back on course, we must be compassionate and fashion those policies that will best meet the needs of the individual American.

WILLIAM V. ROTH, JR., U.S.S.

ADDITIONAL VIEWS OF REPRESENTATIVE MARGARET M. HECKLER

While I do not endorse all of the analyses and recommendations contained in this Report, I join the full Committee in transmitting them as required by the Employment Act of 1946, As Amended, to the Congress.

MARGARET M. HECKLER.

ADDITIONAL VIEWS OF REPRESENTATIVES JOHN H. ROUSSELOT AND CHALMERS P. WYLIE

While we share agreement with the goals to reduce Federal spending mentioned in the spending section of the Fiscal Policy chapter of the Republican Views, we do not agree that deficits should be tolerated even in the short run. William E. Simon, former Secretary of the Treasury, best described the true costs of deficit spending in his book, "A Time For Action."

> Deficit spending does not eliminate the costs of government; it only conceals them. Everything in life must be paid for somehow, and we are paying dearly for our deficits: a national debt of nearly $1 trillion, interest charges of $67 billion a year and rampant inflation spurred by Federal pressure on credit markets and an irresponsible expansionary monetary policy.

Without realizing it, William Simon dated himself in this passage to the October 1980 publishing of his book. The national debt has since passed the $1 trillion mark and gross interest charges on the debt are estimated to be $100 billion, the third largest government expenditure after spending for income security and defense, for fiscal year 1982.

These figures stand as testimony to the government spending excesses and to the lack of fiscal discipline in the Congress. The enormity of the costs we are incurring for past and present deficit financing cannot be understated. As the President pointed out last September, our interest payment on the debt each year is now ". . . more than the total combined profits last year of the 500 biggest companies in the country; or to put it another way, Washington spends more on interest than all of its education, nutrition and medical programs combined."

Because the Federal government has only been able to balance its budget once in the last fifteen years and only nine times in the last fifty-two years, we firmly believe that only through a Constitutional amendment to mandate a balanced Federal budget will Congress begin to live within its fiscal means. Of course, we do not support a Constitutional amendment which would lock Congress in without consideration given to special circumstances that may arise. Flexible consideration must be given the Congress to allow for time of war or national disaster. But while we have reservations in amending the Constitution when statutory means might be able to accomplish the same desired ends, past history has clearly demonstrated the need for a Constitutional amendment to balance the budget. Historical experience shows that Congress has not yet passed a law to balance the budget, so the time has come for dramatic action..

An historic moment occurred on May 19, 1981 when the full Senate Judiciary Committee approved S.J. Res. 58, the Tax Limitation/Balanced Budget Amendment, for Senate floor consideration. This represents the first time that a Constitutional amendment to balance the budget has been referred to the floor of either the House or Senate for consideration. In addition, 31 states are now on record calling for a Constitutional Convention to consider an amendment requiring a balanced Federal budget. Only three more states are necessary for the convention to convene. With these two impending actions, it now appears that Congress will soon give thorough deliberation to this important issue.

John H. Rousselot.
Chalmers P. Wylie.

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